

UNITARY TAX

HEARING
BEFORE THE
SUBCOMMITTEE ON
INTERNATIONAL ECONOMIC POLICY
OF THE
COMMITTEE ON FOREIGN RELATIONS
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CONTENTS

Hearing day:	Page
September 20, 1984.....	1
Statement of:	
Bale, Harvey E., Jr., Assistant U.S. Trade Representative for International Investment Policy.....	23
Caudill, James K., Esq., tax counsel, BATUS Inc., Louisville, KY.....	81
Clarke, Owen L., National Association of Tax Administrators, Washington, DC.....	68
Cory, Kenneth, controller, State of California, Sacramento, CA.....	51
Dillon, Robert, executive vice president, financial division, Sony Corp. of America, Park Ridge, NJ.....	70
Lackey, Mary Lou, regional director of State relations, Motorola, Inc., Boynton Beach, FL.....	141
Lanzillotti, Robert F., professor of economics and dean, Graduate School of Business, University of Florida; former chairman, Governor's Unitary Tax Study Commission, State of Florida, Gainesville, FL.....	158
Mica, Hon. Daniel A., a Representative in Congress from Florida.....	2
Nething, Hon. David, majority leader, State senate of North Dakota.....	88
Pearlman, Hon. Ronald A., Acting Assistant Secretary for Tax Policy, Department of the Treasury.....	10
Shebel, Jon L., president, Associated Industries of Florida, Tallahassee, FL.....	103
Insertions for the record:	
Prepared statement of Hon. Daniel A. Mica.....	5
Prepared statement of Hon. Paula Hawkins.....	8
Prepared statement of Hon. Ronald A. Pearlman.....	15
Prepared statement of Harvey E. Bale, Jr.....	25
Prepared statement of Kenneth Cory.....	54
Prepared statement of Robert Dillon.....	72
Prepared statement of James K. Caudill.....	83
Prepared statement of Hon. David Nething.....	90
Prepared statement of Jon L. Shebel.....	106
Prepared statement of Mary Lou Lackey.....	144
Prepared statement of Robert F. Lanzillotti.....	160
Mr. Cory's responses to additional questions submitted by Senator Murkowski.....	376
Mr. Shebel's response to an additional question submitted by Senator Murkowski.....	377
Appendix:	
A position paper by the Idaho State Tax Commission.....	379
A background paper prepared for the Minnesota Tax Study Commission...	403
Letter to Senator Mathias from Tom Gallagher, State Representative, Commonwealth of Massachusetts, dated Oct. 3, 1984, regarding unitary tax.....	423
Statement of J. Thomas Johnson, director, Illinois Department of Revenue.....	426
Statement of Scott M. Matheson, Governor, State of Utah.....	429
Letter to Senator Mathias from the Chamber of Commerce of the United States of America, dated Oct. 5, 1984, regarding unitary tax.....	432
Statement of the American Federation of State, County and Municipal Employees.....	434

UNITARY TAX

THURSDAY, SEPTEMBER 20, 1984

UNITED STATES SENATE,
SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY
OF THE COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:10 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Charles McC. Mathias (chairman of the subcommittee) presiding.

Present: Senators Mathias, Murkowski, and Hawkins.

Senator MATHIAS. The subcommittee will come to order.

The Committee on Foreign Relations Subcommittee on International Economic Policy will hear testimony this morning on the worldwide application of the unitary tax by several of the States.

This is a subject of more than passing interest to me. The fact is that I served on the original Willis Commission that first studied the problem in 1962 while I was still a member of the other body. Over the years, in the absence of congressional action, the problem has gotten significantly worse.

In those days it was primarily an interstate problem. It was a burden caused by one State on interstate commerce. Today it has taken on a very troubling international dimension. Our trading partners complain with great regularity about the unfairness of worldwide combined reporting, and that is one of the reasons we are holding this hearing today in the Foreign Relations Committee rather than in the Finance Committee or the Commerce Committee.

I recall that when Mrs. Thatcher visited Washington last September, just about a year ago, the question of the unitary tax was on the very top of her agenda in a discussion with President Reagan and with others in Washington. I think the President is sensitive to these complaints and the administration has moved on several fronts to attempt to mitigate the problem.

The Reagan transition team and, subsequently, the Reagan Cabinet Council on Economic Affairs recommended that the President endorse legislation to limit the use of the worldwide unitary tax by the States. In 1981 the Justice Department filed an amicus brief in the Supreme Court in the case of *Chicago Bridge & Iron* in which the administration took a position against the unitary tax.

When the Court handed down the decision in the *Container* case last summer, upholding the California unitary tax, the President then appointed a committee to study the matter. After nearly a year of deliberation, the Worldwide Unitary Tax Working Group released its final report and supplemental views last month.

I would like to ask the witnesses this morning to comment on the findings and the recommendations of that working group and also, in view of the jurisdiction of this subcommittee, we would particularly be interested in hearing your views on the effects of the worldwide unitary tax on international trade and investment.

I think I should enter one caveat, however. The fact that we are holding the hearing in the Foreign Relations Committee should not under any circumstances be interpreted to mean that it is exclusively a problem for foreign-based companies and governments, because we are equally sensitive to the difficulties faced by domestic multinational corporations when the unitary tax is applied to their foreign operations.

We are particularly pleased to have a special panel of witnesses from Florida. Senator Hawkins has been deeply interested in this issue since Florida adopted a unitary tax last year. We are pleased to have as the first witness our colleague from the House of Representatives, Representative Mica of Florida, and I will invite him to come to the witness table.

While Representative Mica is taking his place, let me say that I am pleased to be joined on the bench today by Lord Bridge, who is leading a judicial exchange to the United States and is taking this opportunity to observe the legislative side of the American constitutional system.

Mr. Mica.

STATEMENT OF HON. DANIEL A. MICA, A REPRESENTATIVE IN CONGRESS FROM FLORIDA

Representative MICA. Thank you, Mr. Chairman, and welcome, Lord Bridge. It is a pleasure to have you here today because the subject of unitary tax is obviously an area that your country is tremendously interested in. I might indicate that I am a member of the Foreign Affairs Committee in the other body and the ranking member on the Subcommittee on International Trade and Economic Policy.

What I would like to do is submit for the record a complete copy of my testimony and just summarize.

Senator MATHIAS. Your full statement will be included in the record so that you can summarize as you see fit.

Representative MICA. Thank you, Mr. Chairman.

One of the tremendous concerns I have about the unitary tax, in addition to the international implications, is the fact that over the last year my own State, Florida, passed a unitary tax. So I can give some concrete examples and conclusions that we have reached in Florida.

I am pleased to say today that all indications from the leaders of the Florida legislature, both the House, the Senate and the Governor have almost unanimously agreed to go ahead and repeal Florida's unitary tax. It probably will be done within the next month or two, right after the election, in a special session of the Florida legislature.

So I am very pleased, but that does not take away my total concern or diminish my concern because of the international ramifications. I might say first that the concern over international trade is

growing daily in this Nation and we know that international trade is indeed the future of this Nation.

I think a good indicator of this is the fact that the U.S. Chamber of Commerce, our conservative domestic corporate mouthpiece, the people who speak for U.S. concerns, now spends over half of its budget on international trade issues and staffing international trade matters. I think that is some indicator that we can no longer look domestically to ourselves for growth in solving our own problems. We have to look world wide.

Also, I think yesterday's report on the U.S. trade deficit, the second quarterly report, was \$24.4 billion. As I understand it, we now exceed in two quarters all of last year's trade deficit.

Senator MATHIAS. And that is in spite of the fact, if I might interrupt you, that we are saving \$25 billion a year on oil imports. So it is worse than it looks.

Representative Mica: Exactly. It is much worse.

Many economists are starting to say—and I know this is the political season and an election year, but I think it is going to continue even stronger after the election—that the national deficit, \$200 billion, is one part of the problem, but we cannot begin to address that problem without looking at the trade deficit, which could be another \$200 billion.

So first, with regard to the States' position, in my own State of Florida and all the States that have unitary taxes, I believe there are 11 left. Oregon just repealed. There were 12, and before that there were 13. I am sympathetic to their problems. They have legitimate concerns and the States do have a right to tax corporations.

In our case, the unitary tax was a very quick and not well-thought-out move to gain capital we needed for a worthy goal—education. But, as I have indicated, it appears that that will be changed.

The reactions worldwide to unitary tax have been overwhelmingly negative. Think of a situation where our Allies would have to negotiate with up to 50 different States, different tradees, to do business in the United States. I think from an international standpoint, even from a domestic standpoint, that situation is absurd.

There have been a flurry of condemnations throughout the world. I understand, Lord Bridge, that one of your countrymen, a member of the Parliament, recently introduced legislation in the Parliament for retaliatory measures for any companies that do business with States that have unitary taxes. That is just the beginning.

I think that you mentioned, Mr. Chairman, Margaret Thatcher. Prime Minister Thatcher mentioned it at Williamsburg at the economic summit. It has been mentioned, as I understand it, at almost every economic meeting held by heads of state for the last 4 or 5 years, and it is going higher and higher on the priority list.

Italy, The Netherlands, Japan, Canada, Australia, as well as the United Kingdom, have all lodged formal protests against the unitary tax and again have indicated that they may not, even if they would like to stop retaliatory measures, even be able to stop those actions by their parliaments or legislatures.

The reaction from corporations has been resounding. Last year, right after Florida passed the unitary tax, a British delegation cancelled a trip to Florida with over 40 or 50 members, as I understand, to come in and invest, solely on the basis that we had just passed a unitary tax.

A Japanese corporation—I believe it is pronounced Fujitsu, planned two new plants to be moved out of California into Oregon, \$170 million each, 1,000 jobs each, solely on the basis of the unitary tax.

Again, as you indicate, this is not a new concern. You were here when in the 1960's the Congress started looking at this issue and we have been discussing it. It is not an easy issue. There are no easy answers. But many congressional studies have recommended that we have some kind of harmonization with Federal and State tax laws. I think the impact of unitary taxation is clear. It does interfere with national tax harmonization.

As I indicated, the prospect of having our Allies negotiate treaties with 50 separate States in the United States and no longer deal with our State Department is totally unacceptable. I think it could distort our trade agreements among our trading partners. It obviously is an irritant in international tax and trade policy and it could invite and is inviting retaliation by foreign governments.

It might create an inability of the U.S. Government to negotiate terms that are favorable to U.S. companies, and obviously the concern, if it existed and if the treaties with 50 States were put into place of multiple taxation, could be ruinous to our international standing and our international trade community.

I think that the States' adoption of the unitary taxation on the basis that some States have done it do infringe on the Federal Government's authority to regulate commerce with foreign countries.

Let me skip down a little further here, with regard to the consequences to the States. I have pointed out that it has been negative. I have pointed out a couple of examples. I think it is ruinous in the long term to attract international business to a given State, and very divisive for the United States to have this situation.

The board room decisions are not public, but the results of their decisions have been very clear in Florida. Plant after plant, function after function, has been switched out of our State to other States. Concerns have been raised at meetings with our Governor, with our leaders, throughout the world every time a mention of international business was raised.

The long-term interests of the Federal Government and the State are the same, and that is to improve international trading opportunities, and that helps all Americans.

I would conclude that the Federal Government must indeed and probably would be required to share its information and cooperate with the States on taxation of corporations so that a fair portion of taxes could be paid by domestic corporations.

I have introduced legislation on the House side that would be a "water's edge" type piece of legislation that would not prohibit taxations of multinationals or domestics. It would give the States all rights, but it would stop at the water's edge.

Let me just conclude with a couple of examples. One I already mentioned, the London Chamber of Commerce delegation canceled out immediately and cited as their reason the unitary tax.

A Florida realtor here in Washington just a few weeks ago came to my office and pointed out the fact that he had been negotiating a major deal in the hundred million dollar category for Florida. It was canceled, and he met the realtor at the convention here in Washington who received the deal for a Japanese corporation in Alabama. The sole reason cited for moving it out of Florida to Alabama and canceling the deal was Florida's unitary tax.

The chairman of our tax coalition in Florida, Milton Fisher, says that virtually all inquiries from multinational corporations have come to a standstill, just dried up in the last year since we have had the unitary tax.

A survey of international businesses and banking by the University of Miami found extremely negative attitudes by business managers. Within our State, 38 percent said the Florida tax has encouraged their firms to move some of their operations, if not all of their operations, out of Florida. Thirty-seven percent said because of the unitary tax they expected layoffs. Sixty percent intended to transfer employees out of the State.

I think these are just a few examples. Again, I would say in summary that the States do have a right to tax corporations, but the water's edge concept, I think, would be more appropriate. The Federal Government must share its taxing information so that appropriate taxations can take place. But to move forward and to allow the Federal Government in effect not to act so that we could have a potential of 50 separate States dealing with every one of our trading partners, negotiating 50 separate treaties, would be absolutely unacceptable.

With that I will stop and you can refer to my written statement. Thank you very much, Mr. Chairman.

[Representative Mica's prepared statement follows:]

PREPARED STATEMENT OF HON. DANIEL A. MICA

Mr. Chairman, I am grateful to you for the opportunity to appear before your subcommittee to present my views on worldwide unitary taxation.

International trade is a crucial area, where the Federal Government not only has the constitutional right but also the duty to regulate commerce with foreign countries. Its goal must be to promote U.S. commercial interests and to ensure that this Nation's ability to trade is never impeded.

The importance of international trade to the health of our economy is evident. Without it, this Nation's political and economic power would quickly dwindle away. Many recognize this reality. For instance, the U.S. Chamber of Commerce spends half of its budget on issues concerning international trade. I do not need to elaborate further on the vital importance of international trade to our national well being except to remind you that the trade deficit has become at least as important an issue as the public debt. In fact new Commerce Department figures show that the U.S. trade deficit jumped to a record \$24.4 billion in the second quarter, as the current account deficit for the first half of the year exceeded that for all of 1983.

At the outset, let me also say that I am sympathetic to the arguments which led States to proceed on their own by using worldwide unitary taxation. A State has the undeniable right to expect a corporation to be fully accountable for its fair share of taxes. Unfortunately, in many instances, corporations have avoided taxes by shifting earnings around. In the face of this reality, it is no small wonder that these States have adopted worldwide unitary taxation.

The adoption of unitary taxation by a number of States, including Florida, has prompted a flurry of condemnations and promises of swift retaliation from all quar-

ters. In fact, I have recently been informed that a member of the British Parliament has introduced a motion to take retaliatory steps against the companies of any State that applied the unitary tax to British multinational subsidiaries. Previously, Prime Minister Margaret Thatcher has raised the matter on several occasions both with President Reagan and during the Economic Summit. Other countries have also lodged formal complaints. Among these are Italy, Canada, the Netherlands, Japan, and Australia.

No nation, other than the United States has adopted such a taxation and raised the ire of the international economic community.

Our Special Trade Representative, Ambassador Brock, and others in the Administration including Treasury Secretary Regan, Chairman of the Worldwide Unitary Taxation Working Group, have voiced their alarm at the trade implication of a random unitary tax.

Foreign-based multinational corporations have joined the chorus of domestic multinational corporations in decrying the effect this tax has on their operations. And, of course some have taken remedial action (see examples below). Finally, it has been hotly debated by the States of which a number have already either repealed laws allowing such taxation or abandoned seeking similar legislation. Oregon and Wisconsin have repealed such laws while Indiana, Michigan and Illinois have dropped the issue.

From the Congressional perspective, expressions of concern began in 1964 with a report of a subcommittee of the House Judiciary Committee stating that international tax law should be formulated by the Federal Government and not by individual States. Later, in 1977, a House Ways and Means Committee task force, headed by Congressman Dan Rostenkowski, recommended that Federal income tax rules apply to State taxation of foreign source income. Since then, legislation has been introduced on several occasions.

We must recognize first, regardless of personal philosophy regarding federalism, that State taxation of worldwide income of corporations introduces new wrinkles and distortions that could jeopardize U.S. commerce abroad. The conflict that arises between the States' use of the worldwide unitary tax and the "water's edge" rules used by the Federal Government lead to serious international implications such as:

1. Interference with national tax harmonization objectives;
2. Irritant in international tax trade policy;
3. Retaliation by foreign governments against the United States;
4. Inability of the United States to negotiate a tax treaty on favorable terms to U.S. corporations;
5. A situation whereby foreign governments would have to negotiate a separate treaty with each and every State using a worldwide unitary taxation method;
6. Unitary taxation may result in multiple taxation.

These are legitimate concerns. In the absence of a national policy, a State's adoption of the worldwide unitary taxation method infringes on the authority of the Federal Government to regulate commerce with foreign countries. This nation must speak with one clear voice.

Unfortunately, this issue is fraught with Federal-State dimensions. Many fear Federal interference in State taxation decisions. I am the first to agree that this should be solved at the State level. However, I cannot accept the proposition that the unitary tax and its impact on international trade should be of no concern to the Federal Government. In fact, both the Federal and State governments share the same long term interests of maintaining a good posture in the international trade arena and of attracting business.

However, in the long run, the consequences for a state attempting to attract business are obvious. While boardroom decisions are not the object of public scrutiny, it is perfectly conceivable that a corporation may decide to either relocate or defer planned future expansion to another State where such taxation methods are not used.

In Florida, the passage of "SB-3C" has created a tremendous controversy and the perception of Florida as a good place to do business has been substantially eroded.

Examples

1. A London Chamber of Commerce delegation representing a group of British companies, canceled a trip to Florida to look into the possibility of investing there.
2. A Florida realtor recently told me of a chance meeting with an old classmate from Alabama who happened to also be attending a conference in Washington, D.C. The latter came up to him and thanked him for the business he had made available to Alabama. Why? The Alabama realtor had just signed a deal with a company that canceled plans to locate in Florida following the passage of "SB-3C".

3. According to Milton Fisher, Chairman of the Florida Tax Coalition, over 100 major multinational firms have their offices located in Coral Gables. Typically a number of inquiries are received weekly from foreign and domestic firms considering locating there or elsewhere in Florida. Subsequent to the unitary tax inquiries have virtually disappeared.

4. A survey prepared by the International Business and Banking Institute of the University of Miami found the reactions of company managers to be extremely negative. In general they expect to reduce their business activities in Florida.

Thirty-eight percent stated that the Florida tax has encouraged their firms to move some of the firms operations out of Florida.

Thirty-seven percent expect to lay off employees, and 60 percent intend to transfer employees out of the State.

To the question concerning absorption/passing on the tax, 31 percent expect to raise the cost of products while 28 percent plan to cut back operation in Florida.

5. Fujitsu Ltd. announced recently that it would build two \$170 million computer-parts factories in Oregon. Originally it planned to locate in California until the former repealed its unitary tax law.

In short, the long term attraction of Florida may have been compromised.

As I mentioned earlier, I support a State's basic right to determine its own taxation policy and revenue needs. However, I cannot subscribe to those who criticize the Federal Government for being concerned about the implications of such taxation methods for long term interests of the United States in general and each and every State in particular.

A little over a month ago, I introduced a bill that would prohibit States from using the worldwide income of corporations as the basis for taxation. Were it to pass today, the thrust of the legislation would not take effect until taxable year 1986. I have been informed that the Administration hopes the States will reconsider their law on unitary taxation before next June. It is my personal preference that, during the intervening time, the States will indeed review and repeal these provisions. Federal legislation should be the last resort.

Finally, I welcome the principle put forth by the Worldwide Unitary Taxation working group, chaired by Secretary Regan which calls for increased Federal assistance and cooperation with the State to promote full taxpayer disclosure and accountability. Through better cooperation, the short and long term interests of States will be better preserved.

Senator MATHIAS. Thank you very much, Mr. Mica. Let me ask Senator Hawkins if she has any questions.

Senator HAWKINS. No. I think the Congressman states our position very well. It has been a nightmare since its imposition on Florida. It has given Florida a black eye as far as any new industry coming into our State.

I would just like to warn any State that is considering the passage of such legislation to look at what has happened to Florida in the past 2 years and take that as an example, because we have taken a giant step backward in attracting industry, clean, light industry, that we had been gaining so rapidly. It is unfortunate that this entire episode happened.

Thank you, Congressman, for joining us today.

Representative MICA. Thank you, Senator.

Mr. Chairman, if I might just say to Lord Bridge, if you would take the word back to your country we are trying, thank you.

Senator MATHIAS. Thank you very much for being with us. Let me ask Senator Hawkins if she has any statement she would like to make at this time.

Senator HAWKINS. I have a statement that I would like to submit for the record, but I would also like to commend you, Mr. Chairman, for understanding this problem from the very outset, for having a listening ear and a very willing spirit to conduct these hearings. It is an issue of not only national but international interest.

We appreciate having Lord Bridge with us today. My office is full of correspondence, on this topic from many, many businesses throughout the country. I would like to quote one at this time.

This is from Mr. H.I. Davidson, the general manager of IBM Corp. in Boca Raton, FL, commenting on the unitary tax. He stated:

In the past we found Florida a very good place to do business. Unfortunately, that view has been altered by the enactment of the unitary tax. After the imposition of the unitary tax, IBM put up for sale a 2,000-acre plot it owns near Gainesville to protest Florida's unitary tax.

I think it imperative that the Federal Government reinforce and reemphasize with the States that the arm's length method of accounting remains the only equitable approach to income taxation of foreign commerce. We must give a consistent message to all foreign countries that come to our shores to do business and a loud cry of support for businessmen who are doing business within our borders assuring them that we are not going to change the rules on them midstream.

I thank the chairman.

Senator MATHIAS. Thank you, Senator Hawkins. Your full statement will be included in the record.

[Senator Hawkins' prepared statement follows:]

PREPARED STATEMENT OF HON. PAULA HAWKINS

I would first like to thank the Chairman of the Subcommittee on International Economic Policy, Senator Mathias for his leadership on this issue, and his willingness and enthusiasm in holding this hearing. I also want to welcome Assistant Secretary of Treasury for Tax Policy, Ronald Pearlman, and Assistant U.S. Trade Representative for Investment Policy, Harvey Bale, who have agreed to come and testify on this important subject. In addition, I want to thank and welcome the members of the other panels, especially the Florida panel, Dean Lanzillotti, Mr. Shebel, and Ms. Lackey, for taking time out of their busy schedules to come here so we can give this important issue the attention it deserves.

I am especially pleased that you have called this hearing to discuss the national and international impact of the unitary tax. Let me say at the outset that I have had a great personal interest in this issue since its enactment in the State of Florida and I can speak firsthand about the negative reaction that the imposition of such a tax can generate, both at home and abroad. I would like to be very frank in stating for the record that the unitary tax has been a continuing nightmare since its enactment by the State of Florida. Until its passage 2 years ago, Florida enjoyed one of the most positive national and international images for business, investment, expansion and growth. This tax has been a definite blemish in that record, and has caused national and international concern from both the business and governmental sectors. Based on this experience, I am confident in saying to anyone considering such a form of taxation that such a move will help dim the light of potential business investment and job expansion, and plant a black eye in your State's business image. Since the adoption of the unitary tax in Florida I have had a continuous stream of Florida business leaders, American industrialists and international commerce figures ask for the repeal of this tax. Let me share with you some of the comments I have received: Dr. John Boyd, President of Harris Corporation, Florida's largest employer, has written me, and in his letter called the Florida Unitary Tax "particularly onerous." Dr. Boyd is in a unique position to know because in addition to serving as head of Florida's largest employer, he was a member of the Florida Governor's Unitary Tax Study Commission. Of that study, he said, that it "found clear evidence" of "a negative impact." In addition, H.L. Davidson, General Manager, IBM Corporation, Boca Raton, Florida, commenting on the unitary tax said, "in the past, we have found Florida a good place to do business. Unfortunately, that view has been altered by the enactment of the unitary tax." After the imposition of the unitary tax, IBM put for sale a 2,000 acre plot it owns near Gainesville to protest Florida's unitary tax. These are quotes from only two of the scores of letters protesting the unitary tax.

Mr. Chairman, I'd like to take a few minutes to outline for the Committee the problems created by the worldwide unitary tax, especially in the area of foreign affairs, and then take a look specifically at the problems this tax has brought to my own State of Florida which adopted the unitary method in July of 1983, and with the experience of a little over 1 year has found the impact to be almost universally negative. I would then like to look at what can be done to encourage new investment in the United States with its concomitant job creation without antagonizing and disrupting the relations with our friends and allies abroad.

My own State is a good example of the kind of blackeye the unitary tax can give a State. With adoption at a special session of the legislature in July of 1983, the business tax climate in Florida changed from the most hospitable, fair and accommodating in the country to the most hostile, heavy-handed and over-reaching. Seeking educational reform and unable to reach a consensus between the two chambers of the legislature and business on revenue needs, services and time, the Florida legislature led by the Governor reached for the "quick fix" 1 week after the "Container" decision was handed down.

Since the effort to impose the unitary method occurred in 2 days, there was little if any thought given to the difficulty of compliance, the burdensomeness of reporting or the expense to my State of administering and/or auditing returns.

Multinational corporations must now report worldwide income which must satisfy generally accepted U.S. accounting principles and be in a format acceptable to the Internal Revenue Service and the Florida Department of Revenue.

Furthermore, Florida has now increased its share of income from a corporation doing business in the State by including in sales all sales or deliveries to a purchaser in Florida even though the ultimate destination might be elsewhere. This so-called "throwback" formula adopted by Florida is the most overbearing in the nation. It assigned to Florida, for example, all sales of goods which move from Florida to each of 5 States which have no corporate income tax. The Florida "throwback" rule is doubly-harsh as it is the broadest in the nation and places a 50 percent weighting on sales in the sale, payroll and property formula.

Business reaction to this bill was immediate. Economic development ground to a halt. Governor Graham's own Unitary Tax Study Commission recommended that unitary tax be repealed to "restore" the Federal tax base and separate accounting method of taxation utilized in Florida prior to July 1983. It was clear from the testimony received by the Governor's commission that by endorsing the unitary concept Florida was risking large amounts of current and future capital investment in the State along with substantial employment and other tax revenue pumped into the economy.

During the year that the combined reporting method has been in effect in Florida, new investment has stopped. The panacea of increased revenues has been disappointing. Companies such as IBM and Sony have withdrawn plans to expand or threatened to leave the State. It is certainly in the interest of my State to provide an atmosphere of desirability to new business by repealing the worldwide combined reporting method as recommended by the Governor's own commission. Without repeal, the economy will stagnate and every individual in the State will pay the price. It is interesting to note that prior to the passage of a unitary bill, Florida's economy suffered a slower growth rate, but not a lowering of revenues from its corporate income tax during the recent national international recession. That unique stability of Florida's economy has disappeared with a unitary tax that links Florida to the economic vicissitudes of the rest of the world. What lesson do we learn from the Florida experience? The short-term revenue gains have been sadly disappointing; the long-term investment costs to the State potentially devastating; and this ill-conceived little economic experiment has brought a storm of protest from our friends and allies abroad. I am hopeful that the Governor together with legislative leaders will call a special session to repeal the unitary tax and set Florida back on a dramatic path of growth.

What then can and should the Federal Government do?

First and foremost, uniformity in the regulation of foreign commerce is an essential element in the establishment and maintenance of mutual trade and investment between the United States and other nations. In keeping with this concept of uniformity, an international consensus has been built through years of effort and practice in favor of the "arms-length" method of taxing multinational corporations. Thus, in accordance with established Federal practice and international policy, the taxable income of commonly controlled multinational corporations should be computed and allocated on a separate, arms-length accounting basis.

The Supreme Court in the *Container* case, as well as subsequent decisions has undermined the established arms-length principle. By so doing, there now exists a

clear and present danger of a loss of business investment in this country by foreign companies, growing retaliation by foreign governments and further deterioration in the conduct of United States foreign relations and U.S. foreign trade. The credibility of the U.S. Government has been put in question before the world.

It is imperative that the Federal Government reinforce and reemphasize to the States that the arms-length method remains the only equitable approach to income taxation of foreign commerce. It satisfies all of the criteria for a desirable tax policy including equity, certainty, uniformity, simplicity, and efficiency. It is the internationally accepted method utilized by the Federal Government.

Therefore, in order to avoid chaos and restore order and certainty in our international tax dealings, we should seek preemptive Federal legislation. This will prevent individual States from creating tax problems on a national and international level. Secretary Regan in his report to the President on July 25, 1984, suggested the Federal Government give the States at least 1 year to act to repeal their worldwide combined unitary statutes. I personally believe the Federal Government should provide the impetus to the States to act as quickly as possible to prevent the States from interfering with international investment and trade as well as the further erosion of investment in the United States.

Finally, the United States Government must re-establish its credibility with its trading partners so that the United States may speak with one voice.

Senator MATHIAS. Our next witnesses will testify on behalf of the administration. They are Mr. Ronald Pearlman, Acting Assistant Secretary of the Treasury for Tax Policy, and Mr. Harvey E. Bale, Assistant U.S. Trade Representative for International Investment Policy.

STATEMENT OF HON. RONALD A. PEARLMAN, ACTING ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. PEARLMAN. Good morning, Mr. Chairman. I am Ronald Pearlman from the Treasury Department. Senator Hawkins, Lord Bridge, we would like to extend Treasury's welcome to you. We had the pleasure of meeting last week with John Moore, your financial secretary and the subject of unitary was of great interest to him. I think we were able to bring him up to date on the efforts that have been undertaken by the administration in this regard over the past year or so.

I am appreciative, Mr. Chairman, of the opportunity of being here this morning to offer our views on the subject of worldwide unitary combination. I thought the most productive thing that I could do was to use this opportunity to outline the recommendations of the Worldwide Unitary Taxation Working Group and to express the Treasury Department's support of those recommendations.

As you are aware, the 20-member Worldwide Unitary Taxation Working Group was established at the request of President Reagan in September 1983, to study the very difficult issues raised by the States' use of the worldwide unitary method of taxation. It was chaired by Secretary Regan and composed of representatives of the Federal Government, State governments, and the business community. At its final meeting on May 1, 1984, the Working Group reached an agreement to recommend to the President that resolution of the unitary issue be undertaken by the individual States and that they should be guided by three principles: A water's edge limitation on the application of unitary combination; increased Federal assistance; and competitive balance or nondiscrimination between foreign multinationals, domestic multinationals, and firms operating only within the United States.

The Working Group was unable to reach agreement on two major issues. The Working Group recommended that the so-called dividends issue and the 80/20 issue be left to the individual States to resolve in accordance with the third recommended principle of competitive balance.

The Treasury Department believes that the Working Group's agreement represents very significant progress in resolving the problems perceived to exist with worldwide combination. We have probably seen the high water mark in the States' use of worldwide combination as a basis for taxing multinational corporations. In our judgment, States will now retreat from its use.

Let me give you a little background of the Working Group.

Senator MATHIAS. If I could interrupt you, let me say that that is a pious hope that has been expressed, to my certain knowledge, for over 20 years. For a long time the view was that the States would come together and form an interstate compact that would restrict its use. It was on the basis of these pious hopes that we have postponed any action for a long time.

I did not mean to interrupt your train of thought, but I just thought we ought to flag that hope as being a rather frail reed to lean on.

Mr. PEARLMAN. Senator, we are all predicting, and at this point everyone's judgment is as valid as everyone else's. I would simply suggest to you that a year ago when the President established the Working Group I think people generally concluded that it was a waste of time and that not very much would come out of it, and that indeed it was simply a way to try to sweep the issue under the rug. I would submit that the effort of the Working Group and the consensus that was reached, albeit not a full consensus, and the kinds of things that are beginning to happen, including what we think will ultimately happen in Florida, are indications that all is not lost. But obviously your judgment on that issue is certainly as good as our judgment.

Senator MATHIAS. I agree with you that the Working Group was a useful exercise, but I would point out that this is not merely a case of my judgment. It is a case of proven experience.

Mr. PEARLMAN. Well, we are hopeful that the Working Group effort, and indeed, more importantly, not so much the Working Group effort but the pressure that I think all of the parties to the issue feel, is going to be productive, and indeed we think 1985, perhaps even in some States 1984, is going to show some very significant movement away from worldwide unitary by the States.

If that is true, if that happens, then I would suggest that perhaps 20 years of frustration possibly may not be over but that the climate will improve dramatically over the next year. If we see, for example, California moving away from worldwide unitary, if Florida repeals worldwide unitary, which certainly is a strong possibility in our judgment, if other States indicate a willingness to reexamine worldwide unitary, those are going to be major steps in this country.

We all obviously hope that happens.

Senator MATHIAS. Later this morning we will hear testimony from Mr. Cory, the controller of the State of California. It will be

interesting to find out what the temperature is out there on this subject.

Mr. PEARLMAN. Yes, that is right. Well, permit me to go on.

What I would like to do is just sort of set the stage a bit on how we brought the Working Group together and what the Working Group did. As you are aware, the Supreme Court in the summer of 1983 rendered an opinion in the case of *Container Corporation of America*. The Court's decision was a very significant one because it held that the application of worldwide unitary to domestic multinationals was not proscribed by the foreign commerce clause of the Constitution. And within days of that decision Florida enacted a worldwide unitary combination.

The *Container* decision and the Florida legislation produced an immediate and strong negative reaction from foreign governments and from both foreign and domestic multinational corporations. Foreign governments questioned the ability of the United States to speak with one voice, as you have pointed out previously, and foreign commerce and foreign-based businesses clearly view worldwide unitary combination as an element to consider in making investment decisions, as an impediment to the free flow of investment.

In response to these concerns, President Reagan asked the Secretary to establish and chair the Worldwide Unitary Taxation Working Group. It was charged with trying to reconcile these very divergent views of the States, the foreign governments, and business in seeking a solution to these problems.

The Working Group established a staff-level task force. This task force identified a number of problems perceived to exist with both worldwide unitary and its alternative, namely, separate or arm's length accounting. Among the problems linked to the use of worldwide unitary was that it may lead to double taxation because it is clearly inconsistent with internationally accepted standards of taxation based on separate accounting. The task force also identified several problems with separate accounting, including that when economic interdependence exists between entities in a multicorporate group separate accounting may fail even in theory to accurately measure the income of each entity.

At the May 1 meeting of the Working Group the task force recommended a set of six possible recommendations for consideration. The Working Group agreed to a compromise in which resolution of the unitary issue would be left to individual States in accordance with three fundamental principles, namely, water's edge limitation on unitary combination, Federal assistance to promote full disclosure and accountability, and nondiscrimination in State taxation of dividends and foreign and domestic-based multinationals, as well as strictly domestic businesses.

Since the Working Group did not agree on the appropriate tax treatment of foreign dividends and 80/20 corporations, these issues are left for resolution at the State level in accordance with these three principles.

The fundamental objections to worldwide unitary raised by the foreign multinationals and our foreign trading partners should be answered by virtually any water's edge approach developed in accordance with these three principles.

One issue of significant concern to our foreign trading partners was not addressed in detail by the Working Group. Under the Working Group's water's edge definition, the existence of a U.S. branch of a foreign corporation may cause the entire foreign corporation to be considered as within the water's edge. This may raise serious problems for those foreign corporations, such as banks, which generally operate in the United States through branches rather than separate subsidiaries. Treasury believes that means of treating domestic branches of foreign corporations as deemed or separate subsidiaries in certain cases should be considered at the State level as a way to resolve that issue.

The debate over worldwide unitary has lasted, as you point out, Mr. Chairman, for more than two decades. Treasury believes that the Working Group's three-part agreement represents a significant achievement in bringing an end to this debate. In this compromise States have agreed to retreat to the water's edge in return for increased Federal assistance in their corporate tax administration.

The remaining disagreements, which are clearly important and significant to all the parties, dealing with foreign dividends and so-called 80/20 corporations are issues which the Working Group as a whole agreed are most properly left for resolution at the State level.

Much attention has been focused on Secretary Regan's statement in his letter transmitting his report to the President that he would recommend Federal legislation restricting the States' use of unitary combination to the water's edge if by July 31, 1985, there were not sufficient signs of appreciable progress by the States in implementing the Working Group's recommendations. In light of recent State activity—and I mention particularly California and Florida—emphasis might more usefully focus on a subsequent statement in the letter, namely that, "progress to date gives me reason to hope that it will not be necessary to enact Federal legislation in order to resolve this problem."

In its agreement, the Working Group has called for several Federal measures to strengthen State tax administration. Some Federal legislation clearly will be necessary to implement these Federal initiatives, such as to require the filing of a domestic disclosure spreadsheet and to authorize wider disclosure of taxpayer information to the States and to common agencies performing audits on behalf of the States. We are currently engaged in preparing the legislation necessary to implement these initiatives, and when that legislation is prepared we expect to seek the support of the Congress in enacting that legislation.

In conclusion, Mr. Chairman, let me state that we really believe that the Working Group recommendations of a voluntary federalist approach has an excellent chance of resolving the unitary issue. The Working Group's three principles constitute a viable voluntary solution to the problems raised by the States' use of worldwide unitary.

That the Working Group's recommendation has an excellent chance of resolving the unitary issue does not mean that the Federal interest in this area is at an end. Federal concerns will exist as long as worldwide unitary combination exists. If it becomes apparent that the Working Group's voluntary recommendation is unac-

ceptable to the States, Federal action eliminating the continued existence of worldwide unitary must be considered. However, we are confident that competition for investment will prompt the States to continue to move quickly to adopt a water's edge limitation to unitary combination in accordance with the Working Group's recommendation.

Mr. Chairman, I am going to stop at this point. Again, I appreciate the opportunity of being here. I will be happy to try to answer your questions.

[Mr. Pearlman's prepared statement follows:]

STATEMENT OF
RONALD A. PEARLMAN
ACTING ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ECONOMIC POLICY
OF THE
SENATE FOREIGN RELATIONS COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Treasury Department on the subject of worldwide unitary combination. Rather than cover in detail the issues and arguments surrounding the use of worldwide unitary combination, which I am sure will be covered by other witnesses, I wish instead to use this opportunity to outline the recommendations of the Worldwide Unitary Taxation Working Group and to express the Treasury Department's support of those recommendations.

INTRODUCTION

The twenty-member Worldwide Unitary Taxation Working Group was established at the request of President Reagan in September, 1983, to study the complex issues raised by the states' use of the worldwide unitary method of taxation. It was chaired by Secretary Regan and composed of representatives of the federal government, state governments, and the business community. At its final meeting on May 1, 1984, the Working Group reached an agreement to recommend to the President that resolution of the "unitary" issue be undertaken by the individual states and that they should be guided by three principles in determining the proper income tax treatment of multinational enterprises: a water's edge limitation on the application of unitary combination; increased federal assistance to promote full

disclosure and accountability of corporate taxpayers; and competitive balance or nondiscrimination between foreign multinationals, domestic multinationals, and firms operating only within the United States.

Notwithstanding the significant accord on these three principles, the Working Group was unable to reach agreement on two major issues related to the adoption of a water's edge limitation: the proper state tax treatment of dividends received by domestic parent corporations from foreign subsidiaries, and whether domestically incorporated firms operating primarily abroad, called "80/20" corporations because of an eighty-percent foreign activities test, should be included in the water's edge group of affiliated firms subject to domestic combination. The Working Group recommended that the dividends and "80/20" issues be left to the individual states to resolve in accordance with the third recommended principle of competitive balance.

The Treasury Department believes, despite the Working Group's inability to arrive at a single, comprehensive agreement covering all issues, that the Working Group's agreement on the three principles, including a water's edge recommendation, represents very significant progress in resolving the problems perceived to exist with worldwide combination. We have probably seen the high water mark in the states' use of worldwide combination as a basis for taxing multinational corporations; states will now retreat from its use.

BACKGROUND

In order to appreciate the progress made by the Working Group, it is useful to recall the context in which the Working Group discharged its responsibility to reconcile the interests of the states, foreign and domestic business, and our foreign trading partners in recommending a solution to the "unitary problem." A convenient starting point is the July 27, 1983, decision by the U.S. Supreme Court in the case of Container Corporation of America vs. Franchise Tax Board (No. 81-253). The Court's decision held that application of worldwide unitary combination to domestic multinationals is not proscribed by the foreign commerce clause of the Constitution. Within days of the Container decision, Florida enacted legislation requiring the use of worldwide unitary combination as the means of taxing multinational enterprises. The Container decision and the Florida legislation resulted in immediate and strong negative reaction from foreign governments and from both foreign and domestic multinationals.

Foreign complaints about the use of worldwide unitary are not new, but they greatly intensified after the Container decision. Foreign governments question the ability of the United States to speak with one voice in foreign commerce. Negotiations of some

income tax conventions for the prevention of double taxation have been stalled or postponed because of the unitary issue. Foreign-based businesses clearly view worldwide unitary combination as an element to consider in making investment decisions and as an impediment to the free flow of investment. Whether any foreign investment has been diverted from the United States because of worldwide combination is unclear, but some investments may have been shifted from worldwide unitary states to water's edge states. The possibility of foreign retaliatory action affecting American foreign commercial interests is real and must be taken seriously.

In response to these concerns, on September 23, 1983, President Reagan asked Secretary Regan to establish and chair the Worldwide Unitary Taxation Working Group, which was charged with reconciling the divergent views of states, foreign governments, and businesses in seeking a solution to the problems perceived to exist with the states' use of worldwide unitary combination. In addition to Secretary Regan, membership on the Group included representatives of the White House, the State Department, the Advisory Commission on Intergovernmental Relations, and various state and business officials. Representatives of the states included the Governors of California, Illinois, and Utah, the Speakers of the Florida and New Hampshire House of Representatives, and officials from the National Council of State Legislatures, the National Association of Tax Administrators, and the Multistate Tax Commission. The eight business representatives on the Group included the chief executive officers of seven major corporations, one the subsidiary of a British parent corporation, and an official from a major national trade association. At its first meeting, the Working Group established a staff-level Task Force charged with examining the issues and framing possible recommendations for the Working Group's consideration.

In response to this directive, the staff-level Task Force presented preliminary results of its study of the issues at the second Working Group meeting. The Task Force identified several problems perceived to exist with both worldwide unitary combination and its alternative, separate accounting based on arm's-length pricing. Among the problems linked to the use of worldwide unitary combination was that it may lead to double taxation and distort international trade and investment flows, because it is inconsistent with the internationally-accepted standard of taxation based upon separate accounting which is generally used by foreign countries. Another perceived problem identified by the Task Force was that worldwide combination may impose harsh compliance burdens on foreign-based multinational corporations which must report their worldwide income and apportionment factors in U.S. dollars under accounting principles imposed by the unitary states; for example, a U.S. subsidiary of a foreign corporation may not even have access to information

relating to the activities of the foreign parent or related foreign subsidiaries. The Task Force also identified several problems with the use of separate accounting, including that, when economic interdependencies exist between entities in a multicorporate group, separate accounting may fail, even in theory, to accurately measure income of each entity. According to the Task Force, states may lack the resources to administer taxation based on separate accounting efficiently because of the volume of transactions between multinational affiliates which must be audited on an arm's-length basis.

State representatives on the Task Force also identified several additional problems with imposing federal restrictions on state use of unitary combination. They argued that in the absence of a finding of clear national harm arising from the use of worldwide unitary combination, federal legislation may unreasonably restrict state fiscal sovereignty and deprive the states of significant revenue losses. According to this view, if revenue losses occur because the tax burden of multinationals is reduced, the states must either impose additional taxes on other taxpayers, such as small businesses and individuals, or provide fewer public services to the states' residents.

After evaluating the preliminary findings of the Task Force, the Working Group expressed a strong belief that the only practical solution to the problem must be based on a voluntary federalist solution, rather than on restrictive federal legislation. Thus, the Working Group agreed to rule out, as a possible recommendation, restrictive federal legislation banning the use of worldwide combination, provided that an acceptable solution based upon voluntary action by the states could be found. Perhaps viewed by some as a setback in the search for a solution to the problem, the Working Group's agreement not to seek a "federal remedy" was in fact only a minor concession to political reality. As you know, Mr. Chairman, during the past quarter century, the Congress has been reluctant to approve legislation that would restrict state taxing rights.

THE TASK FORCE OPTIONS

At the May 1 meeting of the Working Group, the Task Force presented a set of six possible recommendations for the Working Group's consideration. The first option, an alternative "activities tax" applicable only to foreign-based corporations, was quickly rejected by the Working Group as being politically unacceptable. The remaining five options were all variants of a water's edge limitation. As such they shared certain common elements, including most aspects of the definition of the affiliated water's edge combined group, a list of state actions to improve tax compliance and administration, and a set of federal measures that would help to insure full disclosure and full accountability of corporate taxpayers.

The five water's edge options differed in their treatment of certain issues upon which the Task Force did not agree. These unresolved issues included the taxation of dividends from foreign subsidiaries, the tax treatment of domestic corporations with primarily foreign operations, the definition of a tax haven corporation, the propriety of a state's reverting to the use of worldwide combination for all taxpayers if a judicial decision allowed it for any taxpayer, retroactive or prospective application of the Working Group's water's edge recommendation, and whether the *de minimus* judicial standards imposed upon the states by P.L. 86-272 should be relaxed.

State members on the Task Force proposed two water's edge options. The first, known as Option 2, would include all dividends repatriated by foreign subsidiaries in the taxable income of the water's edge group. Option 2 would also include "80/20" corporations in the water's edge group. This option was the basis for a proposal suggested by California's Governor Deukmejian at the May 1 meeting. Under this proposal, taxpayers would be allowed to elect between being taxed on a worldwide unitary basis or on a water's edge basis as defined by Option 2. As an alternative to full inclusion of foreign dividends in the state tax base, the states also proposed Option 3, in which foreign dividends, grossed up to include foreign income and withholding taxes, would be adjusted on the basis of the business activity factors of the dividend-paying corporation before being included in the water's edge group's combined income.

Business members on the Task Force, objecting to the inclusion of foreign dividends and "80/20" corporations in the water's edge definition, also offered two options to the Working Group. Their first, Option 4 of the six Task Force options, is substantially the same as current Illinois law and would largely exempt foreign source dividends from state taxation. In response to concerns that Option 4 would significantly reduce state revenues, business members offered Option 5, which would apply a special rule to the state taxation of foreign source income, including interest, royalties, and dividends. Under both of the business options, "80/20" corporations would be treated as being outside the water's edge.

The Task Force representative from the Advisory Commission on Intergovernmental Relations suggested the sixth and final option as a compromise. Although including "80/20" corporations in the water's edge group, the option did not prescribe a specific level of taxation for foreign dividends. It called instead for the issue to be resolved at the state level subject to the qualification that foreign- and domestic-source dividends should be taxed the same.

THE WORKING GROUP COMPROMISE

At the May 1 meeting, the Working Group did not agree on any one of the six options presented by the Task Force. Instead, at the urging of Secretary Regan, it agreed to a compromise in which resolution of the unitary issue would be left to individual states in accordance with the three principles: water's edge limitation on unitary combination, federal assistance to promote full disclosure and accountability, and nondiscrimination in state taxation of dividends and of foreign- and domestic-based multinationals, as well as strictly domestic businesses. These three principles are part of an indivisible package intertwined to assure the states that they would not be asked to limit unitary combination to the water's edge without federal assistance in tax administration and to assure both purely domestic and multinational businesses that neither would be placed at a competitive disadvantage when unitary combination is limited to the water's edge. Since the Working Group did not agree on the appropriate tax treatment of foreign dividends and "80/20" corporations, these issues are left for resolution at the state level in accordance with the three principles.

The fundamental objections to worldwide unitary raised by foreign multinationals and our foreign trading partners should be answered by virtually any water's edge approach developed in accordance with the three principles. Because foreign corporations which do not have significant U.S. business activities would be outside the water's edge, and thus not subject to state taxation, their concerns of double taxation and taxation without representation should be alleviated. Federal concerns over impediments to foreign commerce and international trade and investment would also be reduced. Because a water's edge limitation would exclude from state taxation income arising from foreign activities, many of the problems perceived with the use of worldwide unitary combination would be eliminated.

One issue of significant concern to our foreign trading partners was not addressed in detail by the Working Group. Under the Working Group's water's edge definition, the existence of a U.S. branch of a foreign corporation may cause the entire foreign corporation to be considered as within the water's edge. This may raise serious problems for those foreign corporations, such as banks, which generally operate in the United States through branches, rather than separate subsidiaries. Treasury believes that means of treating domestic branches of foreign corporations as deemed or separate subsidiaries in certain cases should be considered at the state level.

EVALUATION OF THE WORKING GROUP'S RECOMMENDATION

The debate over the use of worldwide unitary combination has lasted for more than two decades at the federal level. Treasury believes that the Working Group's three-part agreement represents a significant achievement in bringing an end to this debate. In this compromise, the states have agreed to retreat to the water's edge in return for increased federal assistance in their corporate tax administration and enforcement. The remaining disagreement -- on foreign dividends and "80/20" corporations -- is on issues that the Working Group, as a whole, agreed are most properly left for resolution at the state level.

When the Working Group convened last fall, many viewed its establishment as an exercise in futility. At its inception, hardly anyone thought the state representatives on the group would agree to any modification of their use of worldwide unitary combination, especially as the representatives on the Working Group included the Governor of California, the historic home of worldwide unitary; the Chairman of the Multistate Tax Commission, the long-time, forceful seat of pro-unitary advocacy; and the Speaker of the Florida House of Representatives, the most recent state to pass worldwide unitary legislation. Conversely, it seemed quite unlikely that the business representatives would join in supporting federal initiatives to promote taxpayer compliance with state taxes. That the Working Group was able to reach an agreement must be viewed as significant progress in resolving this debate.

Much attention has been focussed on Secretary Regan's statement in his letter transmitting the Chairman's report to the President that he would recommend federal legislation restricting the states' use of unitary combination to the water's edge if, by July 31, 1985, there were not sufficient signs of appreciable progress by the states in implementing the Working Group's recommendations. In light of recent state activity, emphasis might more usefully focus on a subsequent sentence in the letter, stating that, "Progress to date gives me reason to hope that it will not be necessary to enact [restrictive] federal legislation in order to resolve this problem." Evidence to support this hope is substantial. On the last day of its session, both houses of the Florida legislature passed measures repealing the use of unitary combination; but differences over related revenue raising measures prevented passage of a single common bill. Oregon's Governor Atiyeh called a special legislative session at the end of July during which Oregon's use of worldwide unitary combination was replaced with combination based on the taxpayer's consolidated federal return. In California, legislation based on Governor Deukmejian's elective approach between Option 2 and

worldwide unitary was passed by the Senate, though not by the Assembly. Indiana leaders have pledged to repeal worldwide unitary combination when its legislature reconvenes in January.

In its agreement, the Working Group has called for several federal measures to strengthen state tax administration. Some federal legislation will be necessary to implement these federal initiatives, such as to require the filing of the domestic disclosure spreadsheet and to authorize wider disclosure of taxpayer information with the states and with common agents performing audits on behalf of several states. Treasury is currently engaged in preparing the legislation necessary to implement these initiatives. It also is assessing what treaty changes would be necessary to enable the states to benefit more fully from our exchange of information agreements. Of course, one should not expect our treaty partners to agree to such protocols without some retreat to the water's edge on the part of the states, but we fully expect that state movement to occur. Treasury is also considering other actions to assist the states with the implementation of a water's edge approach. For example, the Internal Revenue Service has offered interested states the opportunity to send their state tax personnel to be trained in the regular IRS international audit examination courses.

CONCLUSION

Treasury fully believes that the Working Group's recommendation of a voluntary federalist approach has an excellent chance of resolving the unitary issue. The Group's deliberations have clearly defined the issues and will provide a basis for rational, intelligent consideration of those issues at the state level. A rough, but workable, definition of the water's edge now exists. A list of federal actions which will facilitate state tax administration of tax returns filed on a separate accounting basis has been established. The remaining disagreements over "money" issues -- replacement of "lost" worldwide unitary revenues by taxing foreign dividends or "80/20" corporations -- are best resolved at the state, rather than federal, level. In Treasury's view, the Working Group's three principles constitute a viable, voluntary solution to the problems raised by the states use of worldwide unitary combination.

That the Working Group's recommendation has an excellent chance of resolving the unitary issue does not mean that federal interest in this area is at an end. Federal concerns, including impairment of the negotiation of income tax treaties, the possibility of foreign retaliatory actions against American foreign commerce, and the existence of double taxation contrary to the spirit of international agreements, will exist as long as the use of worldwide unitary combination persists. Because the Working Group's solution is based on voluntary action by the states, close federal monitoring of state action must continue. If it becomes apparent that the Working Group's voluntary recommendation is unacceptable to the states, federal action eliminating the continued existence of worldwide combination must be reconsidered. However, we are confident that competition for investment will prompt the states to continue to move quickly adopt a water's edge limitation to unitary combination in accordance with the Working Group's recommendation.

Senator MATHIAS. Thank you. I would suggest that in the interest of saving time we might let Mr. Bale summarize his statement. His full statement will appear in the record. And then we can address questions to you jointly.

STATEMENT OF HARVEY E. BALE, JR., ASSISTANT U.S. TRADE REPRESENTATIVE FOR INTERNATIONAL INVESTMENT POLICY

Mr. BALE. Thank you, Mr. Chairman.

Mr. Chairman, Senator Hawkins, Lord Bridge, I will be both brief and conclusional in my oral remarks. All of the detailed points that I wanted to make are contained in my written statement, which I thank you for including in the record.

That statement focuses on what the Office of the U.S. Trade Representative, and particularly Ambassador William Brock think of the important foreign relations aspects, both political and economic, of the worldwide unitary tax methods used by some of our States. My central theme in that statement is that this method has unfortunate effects, to say the least, on the economic interests of our country as a whole and on our foreign relations.

These effects could potentially become more damaging the longer the worldwide unitary method is retained. Until recently there was great pessimism that this method was spreading among our States. I recall that you, Mr. Chairman, expressed concerns about the unitary tax developments and lack of progress on your proposed legislation to address them 2 years ago in hearings of this committee on overall investment policy.

Senator MATHIAS. A voice in the wilderness, I am afraid.

Mr. BALE. Well, I think, Mr. Chairman, you are no longer in the wilderness but you have quite a crowd around you.

Currently, however, there has been a sea change in the national and States' attitudes toward this system. There is a greater appreciation that worldwide unitary taxation may, and I repeat may, yield more revenue in the short term, but that by deterring considerable business activities it causes longer-term risks, creates longer-term risks that will actually reduce State incomes and employment.

There has also been the discovery of State, Federal, and business cooperation. This cooperation was recently demonstrated by the establishment and efforts of the Worldwide Unitary Taxation Working Group, chaired by Secretary Regan.

This Working Group arrived at principles that go far to resolve the major problems in the existing situation. State and business representatives are called on to cooperate in finding a water's edge solution that maintains competitive balance among all affected taxpayer interests. The Federal Government is moving to assist interested States by providing information and help in supporting State tax officials.

I deal with multinational corporate activities. We now appear to be moving toward the removal of the dead weight loss imposed on our economy and on our foreign relations by the worldwide unitary method.

Concerning possible legislation, we favor legislation at the State level. There has already been progress at the State level among a

number of our States. Florida is cited, and California is working on it, and Oregon has already acted to remove this tax beginning in 1986.

The administration is expectant that the momentum that has begun and which has been encouraged by the Working Group's productive efforts will continue to act to resolve the issues at the State level. The Working Group's efforts represent an excellent example of Federal, State, and business cooperation to sit down and work out on an outstanding public and international issue to the benefit of all.

Federal interference at this time would be an unwarranted, we believe, intrusion into that cooperative effort. And I might say that I do pass along Ambassador Brock's personal compliments to you, Mr. Chairman, and this committee for continuing to publicly review this issue and urge that again this issue be kept in front of us for speedy resolution.

I think in the interest of time I will defer to my written statement in which I tried to lay out some of the analytical difficulties and the concrete economic difficulties that this system presents, and I refer you to that testimony for some more detail.

[Mr. Bale's prepared statement follows:]

PREPARED STATEMENT OF HARVEY E. BALE, JR.

International Trade and Investment
Implications of Worldwide Unitary Taxation

Mr. Chairman, I am pleased to be here today representing the Office of the U.S. Trade Representative to discuss the issue of worldwide unitary taxation. You and the members of this Committee are to be highly commended for continuing a public review of this important domestic and international economic matter.

I have been asked to address the effects of the worldwide unitary tax on international investment and commerce, and to evaluate federal legislation as a means of addressing worldwide unitary taxation. I think this request is appropriate. We, at USTR, are not expert on the more subtle tax points of worldwide combined corporate taxation; however, I think we can contribute a trade and international investment policy perspective, since we work daily on trade and direct investment policy issues.

The Issues

According to recent reports, there are sixteen states which levy a corporate income tax that defines a "unitary" business to include separately-incorporated affiliates beyond their respective state borders. Twelve define unitary businesses beyond our national border. Of these, six states (Alaska, California, Florida, Idaho, Oregon [until 1986], and North Dakota) define a unitary business so that it covers total worldwide operations,

including a foreign parent and any of its separately incorporated affiliates outside of the United States. Thus for U.S. or foreign companies operating subsidiaries in these six states, their tax reporting and tax liabilities must factor into the accounting their global operations.

State authorities have made several arguments in favor of the unitary tax, relative to the separate accounting method (which utilizes arms-length pricing estimates to tax in-state firms). These include: (1) a formula apportionment which utilizes sales, payroll and property elements of a "unitary" business is easier to administer; (2) separate accounting is inappropriate for companies which have integrated operations across state and national boundaries; (3) substantial revenues would be sacrificed. In the view of tax authorities of the states which employ the worldwide unitary method, it is only logical to consider the total operations of multinational companies, whether the parent is U.S.-based or not.

The extra-territorial reach of the tax authorities of worldwide unitary tax states, however, has raised problems for our international economic relations. All of our major industrial country trade partners have requested that a federal legislative or judicial solution be found to eliminate this system of state taxation. Both American and foreign companies, with important business operations abroad also generally oppose use of this tax.

Foreign criticisms of the worldwide unitary tax method include the following: (1) it is inequitable, e.g., even though a U.S. subsidiary may be only a small part of a foreign parent company's global business, state tax liabilities are determined on the basis of the parent's global profits; thus a tax may be due even if the in-state U.S. subsidiary incurs a loss; (2) it conflicts with the tax principles adopted by the Organization for Economic Co-operation and Development (OECD) -- i.e., territorial limits to taxation and arms-length accounting; (3) it imposes great compliance and reporting burdens and uncertainties on multinational companies (especially on U.S. subsidiaries of foreign parent companies) in its worldwide reporting requirements; (4) it creates situations where double taxation is likely to occur where multinationals' returns on their operations abroad are higher than those in the United States; (5) its application creates distortions and uncertainties about the net returns for foreign enterprises from these subsidiaries in the United States, since those returns (net of taxes) will vary in unitary tax states according to fluctuations in worldwide profits, exchange rates, etc., and the climate in non-unitary tax states is uncertain (as they could shift to a worldwide unitary system at any time).

The problems related to worldwide unitary taxation cited above constitute a major part of the concern of the federal government about this system. Unlike a separate accounting or water's edge approach (such as that used by Illinois), the worldwide

unitary tax method raises barriers and uncertainties about our international trade and investment flows and relationships.

Certainly, this tax system would become a serious problem for U.S. commerce if foreign governments took retaliatory steps. An example of this possibility is a proposal that has been tabled in the British Parliament to repeal a rebate of some of the British taxes paid by American companies on those profits earned in the United Kingdom. If this rebate were repealed, there would be reduced overseas dividends to U.S. shareholders and, thus, a worsened U.S. current account balance (at least temporarily). Retaliation against U.S. companies operating abroad would also have adverse longer-term implications for U.S. merchandise trade, as a large proportion (one-third according to the last official estimates) of U.S. exports are delivered to foreign affiliates of U.S. companies. We could very well lose some of our exports if retaliation to our tax practices led to increased taxes and reduced profitability for and investment by U.S. companies overseas. Retaliation becomes more likely the longer we retain the existence in some states (and the future possibility in others) of worldwide unitary taxation.

Our major trade and investment partners (e.g., Canada, Japan, the U.K and the Netherlands) all see the states of the U.S. reaching extra-territorially into the pockets of their companies, shareholders and national treasuries. We have, in fact, received numerous representations at the highest levels from interested foreign

governments on the subject of unitary taxation. The United States has received communications from fourteen member countries of the OECD, both directly and through the European Community, as well as the OECD itself. For example, see Attachment I which contains a submission to the Department of State from the European Community. Foreign governments have informed us that worldwide unitary tax can "chill international investment and decrease efficient allocation of resources and employment opportunities... [and] can impede foreign entry into the U.S. market." Foreign governments believe that worldwide unitary tax represents a "serious obstacle to the further development of our trade and investment relations."

In addition to the danger of retaliation by our developed country partners, which have major investments in the United States, there is also a possibility that developing countries may take our example and adopt a worldwide unitary approach in the future. In spite of the potential negative effect a unitary tax may have on flows of new equity investment, developing countries (which are on the whole large capital importers) could be tempted, given an example by our states' practices, to increase their tax revenue base using this method. I understand that Nigeria is one developing country that has recently been considering adopting the unitary method. Not only would adoption of the unitary method further impede new investment flows to developing

countries, but, once again, returns to the United States on existing direct investments in those countries would tend to be reduced.

Even without the risks of possible retaliation by our trade partners and possible adoption of worldwide unitary taxation by developing countries, we currently harm our national economic, trade and investment interests by utilizing the worldwide unitary method. We have an important political and economic interest in the growth of the developing countries. Our business presence in these countries contributes to their growth, in turn, and it contributes to our own economic health because it helps markets to grow and to expand our trade. Yet, the worldwide unitary tax method could be restricting the growth of our businesses in foreign developing (and developed) countries, because it penalizes U.S. companies which often obtain a higher return abroad on their operations (commensurate with the higher risks of doing business in these countries). The penalty derives from the inclusion of the overseas factors in the worldwide unitary formula coupled with relatively higher average returns overseas, creating a greater tax liability to parent U.S. companies.

We also penalize and discourage foreign investments in the United States by the worldwide unitary tax. The increased tax liabilities, administrative and reporting costs and uncertainties associated with the worldwide unitary approach are increasingly leading

foreign investors to re-evaluate proposed investments in unitary-tax states. The Japanese, British and French federations of industries have all taken public positions that the worldwide unitary method is an obstacle to investment in some of our states.

Some investment missions to unitary tax states have been cancelled, and some foreign investments have been shifted between states as a result of foreign objections to this tax. One recent example involves a leading Japanese computer manufacturer, Fujitsu, which announced on September 12 that it will invest \$170 million in magnetic disc and semiconductor production facilities in Oregon, as a result of the recent decision by that state to repeal worldwide unitary taxation. Fujitsu's investment in Oregon is expected to result in 1,000 new jobs. Fujitsu had considered expanding existing facilities in California, but abandoned this plan in favor of the Oregon site due to California's unitary tax. Press reports have also indicated recently that Sony Corp., Kyocera Corp. and NEC Corp., all of Japan, have plans to invest in Oregon and Washington to avoid the reach of California's unitary tax. Finally, it has been reported that the Japanese business federation, Keidanren, has released a study showing that Japanese companies would invest \$1.4 billion more in California if the unitary tax were repealed.

It has been argued by some observers that the worldwide unitary tax practices of some states would not reduce the overall flow of direct investment to the United States, but only tend

change its geographical distribution. This argument against considering the worldwide unitary tax as an increased investment deterrent could be supported by data showing the large increase in foreign direct investment in the United States in recent years. The importance of foreign direct investment to the United States as well as the growth in importance of the United States as a market for foreign direct investment is shown in Tables 1 - 4. In addition, the Department of Commerce recently announced that foreign direct investment in the U.S. totalled \$133.5 billion at the end of 1983. This represents a 9.5 percent increase from 1982 and a 95.3 percent increase from 1980. Foreign direct investment in the United States has since 1980 grown at an average annual rate of 18 percent.

Foreign direct investment has become a more significant and more pervasive factor in our economy -- the ratio of foreign direct investment in the U.S. to U.S. direct investment abroad has risen from 20 percent in 1973 to nearly 60 percent in 1983. Further, the contribution of foreign direct investment to domestic investment and savings has risen as well. In 1973, flows of foreign direct investment into the United States amounted to 3.2 percent of net private domestic investment and 1.6 percent of domestic private investment. In 1983, the ratio of foreign direct investment to total domestic investment spending and to gross savings rose to 12.0 percent and 2.0 percent respectively. Additionally, foreign investors in the United States employed 2.3 million persons in 1981, a 107.6 percent increase from the

number of persons employed by foreign subsidiaries in 1977.

In spite of the growth of foreign direct investment in the United States, I believe that the worldwide unitary tax could become an increasingly significant obstacle to the flow of direct investment to the country overall, and not just to states which actually employ worldwide unitary taxation. Unless foreign investors have some assurance that they will not be strapped with worldwide unitary taxation, they may become increasingly reluctant to invest even in non-unitary tax states. An investor has to take a long view. In recent years, both foreign and domestic investors have become very uncertain about the trend of developments in state tax policy.

Last year, the White House released a statement outlining the Administration's investment policy. It stated that:

The United States has consistently welcomed foreign direct investment in this country. Such investment provides substantial benefits to the United States. Therefore, the United States fosters a domestic economic climate which is conducive to investment. We provide foreign investors fair, equitable, and non-discriminatory treatment under our laws and regulations.

Foreign investors believe that the worldwide unitary tax system is unfair, inequitable and, because most of their operations

are located elsewhere in the world, discriminatory relative to the treatment of U.S.-based companies.

Proposed Remedies:

I have been asked to comment on the appropriateness of federal legislation. A critical consideration affecting our judgment on this is the recent accommodation achieved by state and federal officials and business leaders on certain principles in this area of taxation in the context of the work of the Worldwide Unitary Taxation Working Group chaired by Secretary of the Treasury Donald Regan. The principles are set forth in the recently issued Report of that group.

Briefly, the principles agreed to by the Working Group include: (1) a shift away from a worldwide to a water's edge unitary approach; (2) federal assistance to provide information and cooperation to assure full disclosure and accountability of taxpayers; and (3) agreement that state tax practice should maintain competitive balance between foreign and domestic-based multinationals and domestic non-multinational companies. Secretary Regan has directed the Treasury Department to move immediately to implement the second principle. The Working Group could not resolve the related issues of taxation of foreign source dividends or the proper tax treatment of U.S.-based multinationals operating primarily abroad because of the inability of state and business representatives to reach agreement. These issues

have been left for resolution at the state level in accordance with the competitive balance principle. Nor was the Working Group able to resolve issues relating to the proper tax treatment of foreign-based banks operating in the United States through branches rather than affiliates. As U.S. branches of foreign banks operating in the United States would generally exceed the threshold-business-activities test suggested in the Working Group report, the water's edge combination approach would continue to include the activities of the entire foreign banking corporation. We understand that our trading partners are troubled by this. In fact, this problem was highlighted by the Japanese delegation in meetings of the U.S.-Japan Investment Committee just this week. Secretary Regan has recommended to the President that means of treating domestic branches as subsidiaries under certain conditions should also be explored at the state level.

The report of the Working Group should give many who are concerned about the issues surrounding unitary taxation solid grounds for optimism. If the principles adopted by the Working Group are adopted by the state and federal governments, we will have been able to dispose of this issue as an irritant in our international economic relations and distortion to trade and investment flows.

In fact, in recent months, we have seen a trend away from the worldwide unitary tax method.

- In a special session at the end of July, the state of Oregon repealed their use of worldwide unitary combination effective in 1986.
- State government leaders of both political parties in Indiana have publicly pledged that, regardless of the results of the gubernatorial election this November, worldwide unitary combination in that state will be replaced in January.
- On the last day of the legislative session in Florida, both House and Senate passed separate bills repealing worldwide unitary combination. However, the two bills contained separate revenue measures that could not be reconciled. Florida therefore remains a worldwide unitary state but state government leaders have made public their intention to re-introduce repealing legislation next term.
- During the recent legislative session, the California Senate passed legislation allowing multinationals the option of water's edge unitary taxation, with taxation, however, continuing on foreign dividends. The California Assembly was unable to pass the measure, because it was opposed by U.S. companies who argued that the foreign dividends provision would put them at a competitive disadvantage.

- Other unitary states, particularly Massachusetts, are also reviewing their tax structures with a view to repealing worldwide unitary tax apportionment.

There can still be pitfalls in the effort to shift from a worldwide to a water's edge approach, as is evidenced by the conflict between state and business interests in California. Yet, we believe that most state officials are coming to realize that the worldwide unitary tax approach is a clear negative factor for everyone in the long-term and that cooperation is preferable. Hopefully, compromise solutions will be found where difficulties currently exist in changing current state tax practices.

Therefore, in light of the recommendations of the Working Group, we do not believe that federal legislation is appropriate. We should allow forces in the direction of positive change in the states to develop and gather momentum, without federal interference.

The Working Group's efforts represent an excellent example of federal, state and business cooperation to sit down and work out a solution to an outstanding public and international issue to the benefit of all. Federal interference would constitute an unwarranted intrusion now into that cooperative effort.

ATTACHMENT I

(Submission to the Department of State on Behalf of the European Community Governments, August 1, 1983)

UNITARY TAXATION

- I. Our governments refer to their note on unitary taxation forwarded to the Department of State by the Embassy of Belgium on 29 June 1982.
- II. That note drew the attention of the State Department to the case before the Supreme Court of the Container Corporation of America versus the California Franchise Tax Board and urged as a matter of high priority that the government of the United States should participate in that case as *amicus curiae*. The decision was handed down by the court on 27 June, 1983, and the court found that application of the unitary business principle by the State of California to Container Corporation and its foreign subsidiaries was proper. A majority of justices held that that fact that no brief had been submitted on behalf of the United States government meant there was no indication that the position taken by the government in the case of the Chicago Bridge and Iron Company still represented its views or that the brief in the Chicago Bridge case applied to the Container case.

III. Although the Supreme Court decision did not apply to US companies with foreign parents, our governments were disappointed by the Container decision. They remain convinced that the unitary basis of taxation with combined reporting, particularly as applied in the international field, is unsatisfactory. Our governments therefore urge that the United States government should give strong support to legislation to ensure that States do not use that method of taxation at least for the subsidiaries of foreign corporations. There are currently two relevant bills in Congress, HR 2918 and S.1225.

IV. It is particularly important that federal legislation should be adopted at an early stage since there are already signs that, following the decision in the Container case, other American States not at present using this method are contemplating adopting worldwide combined reporting.

TABLE 1

U.S. Direct Investment Inflows and Outflows: 1965 - 1983
(\$ millions)

	<u>Flows of Foreign Direct Investment to the U.S.</u>	<u>Flows of U.S. Direct Investment Abroad</u>	<u>Net (1) - (2)</u>
1965	415	5,010	- 4,595
1966	425	5,416	- 4,991
1967	691	4,807	- 4,116
1968	807	5,295	- 4,488
1969	1,254	5,960	- 4,706
1970	1,464	7,589	- 6,125
1971	367	7,617	- 7,250
1972	949	7,746	- 6,797
1973	3,681	11,353	- 7,672
1974	4,760	9,052	- 4,292
1975	2,603	14,244	-11,641
1976	4,346	11,949	- 7,603
1977	3,728	11,893	- 8,165
1978	7,897	16,056	- 8,159
1979	11,877	25,222	-13,345
1980	13,666	19,238	- 5,572
1981	21,998	9,680	+12,318
1982	14,865	-4,755	+19,620
1983	11,299	4,881	+ 6,418

SOURCE: Survey of Current Business, U.S. Department of Commerce

TABLE 2

U.S. Outward and Inward Investment Position

	(1) US Direct Investment Position Abroad (\$ Millions)	(2) Foreign Direct Investment in the US Position (\$ Millions)	Ratio of Inward to Outward $(2) \div (1)$
1973	101,313	20,556	.20
1974	110,078	25,144	.23
1975	124,050	27,662	.22
1976	136,809	30,770	.22
1977	145,990	34,595	.24
1978	162,727	42,471	.26
1979	187,858	54,462	.28
1980	215,375	68,351	.32
1981	226,359	90,421	.40
1982	221,512	121,885	.55
1983	226,117	133,479	.59

SOURCE: Survey of Current Business, U.S. Department of Commerce,
(various issues)

TABLE 3

Inward Direct Investment Flows:
Percentage Distribution Among 13 Countries

	1961-67	1968-73	1974-78	1979-82
Canada	16.2 %	12.1 %	3.2 %	(Negative)
United States	2.6	11.4	26.7	50.9 %
Japan	2.0	1.7	1.2	1.0
Australia	15.6	12.9	9.5(1)	6.6
Belgium	4.5(2)	6.1	9.4	6.2
France	8.2	8.2	15.2	8.6
Germany	21.3	16.4	14.7	3.0
Italy	11.5	8.3	5.0	2.4
Netherlands	4.7	8.5	6.0(3)	4.5
Sweden	2.4	1.7	0.5(4)	0.6
United Kingdom	9.7	7.4	6.1	11.8
Spain	2.7	3.7	3.7	5.6
Norway	0.8	1.4	4.1	1.4

- 1) From 1974 to 1976
- 2) From 1965
- 3) From 1974 to 1978
- 4) from 1974 to 1977

SOURCE: International Investment and Multinational Enterprises:
Recent International Direct Investment Trends, OECD, Paris,
1981; Balance of Payments Yearbook, International Monetary
Fund.

TABLE 4

Foreign Direct Investment in the U.S.
Relative to Domestic Investment
and Savings
1965 - 1983

	(1)	(2)		(3)	
	Flows of Foreign Direct Investment to the U.S.	Net Private Domestic Investment	Ratio (1)÷(2)	Gross Private Domestic Savings	Ratio (1)÷(2)
	(\$ Millions)	(\$ Billions)	(in pct.)	(\$ Billions)	(in pct.)
1965	\$ 415	\$ 57.5	0.7	\$ 119.7	0.3
1970	1,464	56.2	2.8	158.6	0.9
1971	367	69.9	0.5	180.3	0.2
1972	949	88.6	1.1	189.2	0.5
1973	3,681	113.3	3.2	227.7	1.6
1974	4,760	92.7	5.1	234.5	2.0
1975	2,603	46.8	5.6	282.7	0.9
1976	4,346	82.8	5.3	294.4	1.5
1977	3,728	128.9	2.9	326.9	1.1
1978	7,897	164.1	4.8	374.0	2.3
1979	11,877	167.0	7.1	407.3	2.9
1980	13,666	108.7	12.6	435.4	3.1
1981	21,998	145.4	15.1	509.6	4.3
1982	14,865	55.3	26.9	521.6	2.8
1983	11,299	93.9	12.0	567.8	2.0

SOURCE: Survey of Current Business, various issues
Economic Report of the President, February 1984

Senator MATHIAS. Thank you for your oral testimony and for assisting us by submitting copies of your written statement so that we could review it in advance.

Let me start out by quoting from article I, section 8 of the Constitution, in which it is provided that, among other things, "The Congress shall have power * * * to regulate commerce with foreign nations, and among the several States and with the Indian tribes."

Now is there any doubt in the mind of the administration that this is full authority to deal with this problem as the Congress may see fit to deal with it? In other words, is there any legal problem?

Mr. PEARLMAN. As you are aware, Mr. Chairman, the Congress has on one prior occasion acted under the Commerce clause, Public Law 86-272, I think is the number. I do not think that we would suggest that there is a constitutional limitation on the ability of Congress to act in this area. Now obviously the States have a constitutional right to raise revenue, but no, I do not think we would suggest that Congress' decision to enter this arena had a constitutional restriction on it.

Senator MATHIAS. So the voluntary approach suggested by the Working Group is based on policy and not on any lack of authority?

Mr. PEARLMAN. Yes; I think that is correct. It is a policy judgment that if these issues can be resolved among the States and business that that is a more constructive way of dealing with the issue than getting the Federal Government involved, except to the extent necessary. And, as I indicated to you, we have already made it clear that there must be some congressional involvement implementing our part of the bargain of providing some Federal assistance to States.

Senator MATHIAS. It is my understanding that at the time the Working Group submitted its report Secretary Regan said that if the States have not acted on their own to resolve the problem he would recommend that the administration sponsor legislation. Is that correct?

Mr. PEARLMAN. That is correct. The Secretary made it clear in his transmittal to the President that if he did not see a movement on the part of the States by July 31, 1985, he would recommend to the President that the administration open the subject of Federal legislation again. I would state again, however, because there has been so much attention directed to that statement by the Secretary that the emphasis that the Secretary made was attention to this issue by the States, and we clearly are seeing attention to this issue by the States. Whether next July either the Secretary, Members of Congress, or others will perceive that movement by the States as being meaningful or significant, only time will tell. But what could happen over the next year—and I point again to both Florida and California—is very significant.

Senator MATHIAS. I hope you are right, and I trust that you are right. But I would urge you to take a look at the history of the interstate compact effort on this subject. The pattern is: a few States join and a few drift off.

If pressure is not maintained, there will be no significant State action, I am convinced, because there is a high degree of reluctance on the part of the States to accept this.

Mr. PEARLMAN. I agree with you, Mr. Chairman. I think the pressure is very important. I think the pressure really is multifold. The incentive, for example, of making a meaningful and serious offer to the States of some Federal assistance that they heretofore did not have, in a sense, is some pressure. Clearly the States are feeling the pressure that Senator Hawkins mentioned before, that this is having an effect on investment decisions that business is making, and that cannot pass the sensitivities of people in States where unitary is currently the law. I completely agree with you and I think clearly the administration agrees with you that it is important to keep pressure on this topic. I would join my colleague from USTR in suggesting that your efforts in that regard are very helpful.

Senator MATHIAS. On that happy note of agreement, let me yield to Senator Hawkins for her questions.

Senator HAWKINS. Thank you, Mr. Chairman.

I think Washington has an inclination to study something to death, to order more groups to meet together, more reports, and more paperwork for us to read. In his chairman's report, as I read it, Secretary Regan said he was prepared to take action on this issue if no appreciable progress is made by July 1985.

What is "appreciable progress"? Do we have a definition of that?

Mr. PEARLMAN. Obviously, Senator, it is a subjective standard and was intended to be a subjective standard. Clearly what we mean is we want to see States moving by legislative action away from unitary to the Working Group's recommendation for water's edge.

Senator HAWKINS. So your definition today is that you expect to see legislative action. Just forming a unitary tax study commission and having it come in with recommendations does not mean meaningful progress?

Mr. PEARLMAN. I certainly do not want to prejudge what kind of decision the Secretary might make in July 1985 or what kind of standard he may use, but I think we are all anticipating that there will be action by States, specific, positive action by States. That is what our anticipation is.

I do not think that we are trying to encourage continuing study and delay. Again, I think many people suggested that that was what the Working Group was all about, and in retrospect, I just think that that is an unfair statement. I think the Working Group did do something. I do not credit what the States are doing to the Working Group, but I do credit it for the fact that the parties are talking.

The parties are at the table and they are talking. Everyone, both foreign multinationals and domestic multinationals, and States recognize that it is in everyone's interest to get this issue resolved.

Senator HAWKINS. Well, people like to talk; I will agree with that part of your statement. I like to act. I understand that the USTR's office was not represented on Secretary Regan's Worldwide Unitary Taxation Working Group; is that correct?

Mr. PEARLMAN. That is correct.

Mr. BALE. Yes.

Senator HAWKINS. So everybody is not talking.

Mr. PEARLMAN. I think it would be inaccurate to say that USTR has not had a very active involvement. Let me say this. The administration clearly was represented not only through Secretary Regan, but there was other Federal representation on the Working Group, including Jack Svahn, Assistant to the President for Policy Development and Allen Wallis, Under Secretary of State for Economic Affairs. And the USTR has been heavily involved in the development of the administration's options. They have clearly not been excluded from this process.

Senator HAWKINS. Given the potential impact this tax could have on our relations with our trading partners, in your opinion why was the USTR's office not represented in the Working Group?

Mr. PEARLMAN. In making a decision of who the members of the Working Group would be, we simply made a decision that we wanted to keep the size of the group down as low as possible. It was simply the whole issue of how many businesses were represented and how many States were represented, and how many components of Government were represented. It was a numbers decision, that if the group got too large it would become unwieldy and that decisions could not be reached. Clearly, through White House representation all segments of the administration were represented. I can assure you that all of the views of the administration were heard in the deliberations of both the task force and the Working Group.

Senator HAWKINS. The States tried to make the case that they need the unitary tax because it gives them a better handle on the actual business activity conducted in the State and it is less distortive. But if the worldwide unitary tax is not distortive, why was the arm's length or separate accounting method adopted as the international standard?

Mr. PEARLMAN. We think that, properly applied, the arm's length standard is the best way to determine taxation within an international context. The problem—and we all recognize it, including the business groups—is the one that the States have raised and the ones that we addressed in the Working Group, and that is, in order to properly apply a separate accounting standard based on arm's length pricing, it is necessary to have information. It is necessary to have full information about the activities of a multi-entity, multinational corporation. Heretofore, the States have not had that full information.

One of the key components to the Working Group recommendations and the one for which we have principal responsibility is to make sure that that argument is no longer valid. That is, that by Federal action we will be able to say to the States that if you adopt a water's edge approach and in effect go to a separate accounting concept you will have the data available so that an accurate application of separate accounting can be made.

We think that separate accounting does become the most accurate way to determine that portion of taxable income which should be subject to tax within a particular State, and I would suggest to you that the States certainly to the extent represented on the Working Group have recognized the importance of that component of the agreement to the use of a water's edge solution.

Senator HAWKINS. When a tax treaty is signed between the United States and a foreign country, should not all political subdivisions and some governmental divisions—i.e., States, counties, cities—within each country be bound by the treaty?

Mr. PEARLMAN. Senator, I guess I would say to you that, for the most efficient and least traumatic way of doing business, the answer to your question is yes.

The problem which traditionally in this country we have always thought was a good idea is that there is a recognized division of authority between States and the Federal Government in the matter of taxation. The Congress has traditionally stayed out of the arena of trying to govern State taxation and there is a long tradition in this country of trying to keep the subject of State taxation out of our treaty process, as it has been kept out of the legislative process.

So from a pure efficiency standpoint I would answer your question yes. From a standpoint of how our system of government is structured, I would suggest to you that at least the decision that has been made over the many years of treaty negotiations and the legislative deliberations in this country is that the Federal Government should stay out of the area of State taxation to the maximum extent possible.

Senator HAWKINS. Then how are tax treaties affected by the worldwide unitary tax?

Mr. PEARLMAN. There is clearly an effect. There is no question about it. Worldwide unitary taxation and the selection of worldwide combination by States has had an effect on treaties and has had an effect on our treaty negotiations. As Mr. Bale pointed out and as other people have pointed out, as the chairman has pointed out, there is an international implication to the use of worldwide combination. That is why we took the initiative we did.

It does have an effect on our treaty negotiations. But to reach an immediate conclusion that the only way to deal with it is by dealing with it through a treaty—and we all remember rather sensitively the experience in the United Kingdom treaty, which did try to deal with it and which was not ratified as a result of that—that we think the best way to deal with it is to bring the parties to the table, which we hope we have begun to do.

Senator HAWKINS. Thank you.

Mr. Bale, I understand that the U.S. Government is trying to encourage the GATT [General Agreement on Trade and Tariffs], to expand its area of jurisdiction from an emphasis on transfers relating to goods to one that also provides protection for services and investments. This is because so much of U.S. business activity worldwide is service and investment oriented.

Considering the tremendous paperwork and administrative burden imposed on business operating under the unitary tax, does not the unitary tax act as a kind of nontariff barrier to entry for foreign investors? If this is the case, does this not mean that our States are adopting tax legislation that runs contrary to what the Federal Government considers to be the best direction for our trade policy?

Mr. BALE. Yes, Senator, that is clearly the case. The problem that is presented for unitary tax, as I have tried to point out in my detailed comments—and I will try to summarize those now—

Senator HAWKINS. Would you speak up a little?

Mr. BALE [continuing]. Presents both entry problems and problems for businesses once they have entered into business within the United States, and in particular in those States that have the unitary tax.

Now for those States that do have unitary tax and the worldwide combination method, the problem that arises is that these foreign-based companies have so much of their operations overseas their parent companies at home and their affiliates worldwide become subject to the reach of individual States.

This clearly has a deterrent effect for companies when considering operations in the United States in those States that have this tax, and this has been clearly illustrated, as Congressman Mica pointed out, in the case of Fujitsu and the decision to expand investment in Oregon as opposed to California.

Now the problem that I think exists also for the United States generally—and this is an economic problem for us—is the uncertainty that businesses have even for States that may not have the unitary tax, given the trend that up until very recently was taking place. So this has an implication for our U.S. national interest beyond the State borders of those States that in fact employ the worldwide combination method.

We think this has a deleterious effect on foreign investment in the United States. We think it has a deleterious effect on our trade abroad because clearly if a U.S. multinational operating overseas commensurate with the risks of operating abroad has high returns abroad this becomes a proportional factoring that takes place embedded in the taxing State.

If that discourages our companies abroad to sell our goods abroad, then that also has implications for trade and investment and employment.

Senator HAWKINS. Thank you. That is all I have.

Senator MATHIAS. Thank you. I have just two very brief questions.

One of the proposals of the Working Group was to give the States access to corporate tax records. How did the Working Group think that would be a compensatory factor that would encourage the States to abandon the unitary tax?

Mr. PEARLMAN. I think it is fair to say, Mr. Chairman, that the principal complaint the States have made over the years to the so-called arm's length method or separate accounting method has been one of not being able to properly apply it because of the lack of adequate data. In other words, they did not have data on the entire enterprise and therefore could not properly apply the concepts of an arm's length method. What this system will do, what the Working Group option does, is design a so-called spreadsheet whereby the worldwide activities of a business are identified so that the data needed to properly apply an arm's length method is available. Obviously there is a collection problem and there is an analytical and dissemination problem.

It made sense to everyone—to business, to States—that that function of collecting, analyzing and disseminating that data should occur at the Federal level. We are under constraints in doing that. We do not now have the statutory authority to collect

and distribute that kind of data on one business to a State, because of the limitations placed on the Internal Revenue Service in obtaining and disclosing tax return data. That is an item that is of great interest to the States, clearly of interest to the States. Business took a very up-front approach on that. From the very beginning they said "we are not refusing to provide data, and if the States' criticism is they do not have data, then let us work out a way to provide the data."

Senator MATHIAS. I agree that is the right way to go.

Mr. PEARLMAN. So we think we have designed a procedure which should be very easy to implement and that will be of substantial benefit to States. But there is a price they have to pay for it, namely, they have to move away from worldwide combination on a mandatory basis, and to the extent they do, then hopefully, if the Congress shares our view that this does give the States the missing link, if you will, or fill in the response to the principal argument they have made, then the States will have the data that they claim they need to properly apply an arm's length method. But we cannot do that without legislation.

Senator MATHIAS. Let me ask this final question, if either of you knows the answer. Those who defend the concept of the unitary tax assert—and this is a classic assertion; it has gone on for 20 years and the figure may change a little but the basic argument is the same—that the States will lose revenue.

In fact, they have even estimated that the States will lose \$730 million in revenue—it is a crystal ball that I would like to own, if you could predict that accurately—if they are forced to discontinue the use of the unitary method. Did the Working Group analyze that State loss of revenue?

Mr. PEARLMAN. No, Mr. Chairman, the Working Group did not. You are correct that there are assertions by each State of the magnitude of the revenue loss. There are assertions on the other side by business that that revenue loss is overstated and that the proper application of the arm's length method should produce the appropriate amount of revenue. The problem we have is that Treasury has no data on which to make that kind of determination, so we just have not.

Senator MATHIAS. We always estimated in the days of the old Willis Commission that if you adopted some standard three-factor formulas that the States would do as well or better because the information, the formula would be simple. It would be clearly understood by business. Business would recognize its obligation and that obligation could be enforced.

So I am inclined to believe that these astronomical estimates of revenue losses to the States are really imaginary. But it is a question of judgment, Mr. Pearlman, on that.

Mr. PEARLMAN. Unfortunately, the facts simply did not permit us to assist in that.

Mr. BALE. Mr. Chairman, if I might supplement that, I am not a tax expert. I am just a simple trade negotiator. What I have seen based upon businesses who have come into our office and who also visit the Treasury Department is that clearly today foreign companies and American companies are much more sensitive to competitive pressures and costs. Costs include taxes.

I do not want to use too many technical terms, but the elasticity, the responsiveness of business to these tax differentials I think is growing. This is just based upon casual empiricism or the contacts that we have had with both foreign and domestic businesses. But, too, think, as you do, that these are overestimated figures.

I understand also they are figures that seem to be based upon a heavy emphasis on revenues collected from particular industries rather than a broad spectrum of industries that would reflect the kind of new investment that States are trying to attract—the light industries that Senator Hawkin made reference to earlier.

So I just wanted to make that point because we have not done the analysis either. We are certainly in our office not in a position to do that, but I'll tell you the word is out that this thing can cost you upwards of 25 percent more or several hundred percent more if you do as much as 20 percent business overseas. That seems to be the threshold that some people have calculated as to when the harmful effects begin to take hold.

Mr. PEARLMAN. If I might, Mr. Chairman, let me add one more comment, and that is no one, and I include the States in this, but clearly the Treasury Department, and I think I would fairly say the administration looks at this issue as one in which we should seek to reduce any business's tax liability. That is not the problem here.

It is not a question of "Is a foreign business paying too much tax in the United States?" The question here is, "Is the foreign business paying the right amount of tax in the United States?" Are we appropriately applying tax concepts to multinational businesses? There is no objective here to favor foreign businesses over domestic businesses. Clearly we do not want to do that. We want all businesses conducting business in the United States, whether they are small businesses, large domestic multinationals or foreign multinationals to pay tax in the United States fairly determined, and that is the issue involved in worldwide unitary.

Senator MATHIAS. I think you are absolutely right, and that is very well worth adding. That is the point I tried to make in my opening statement, that we are not trying to create a better climate for foreign investors here or foreign businesses here, but simply to insure that every business pays a fair share.

Mr. Bale, let me make a final observation. You said very modestly that you are not a tax expert but a simple trade negotiator. The two may be merging. We held hearings in this room several weeks ago on the subject of automobile trade and we had senior officials from Ford, General Motors, and Chrysler. I asked them a question.

On a scale of 10, how would you rate your trade problems? And they said five. They would rate as five the currency exchange problem, the unreal relationship between the dollar and the yen, and the other five points, I was very much interested, were not assigned to high labor costs or inefficient production or any of those factors. They said they felt pretty competent to deal with that competition.

The other five points were the tax problems that beset the automobile industry, the lack of symmetry between the Japanese tax system and the American tax system, which ended up in a dis-

criminatory impact on American industry. So what we do in taxation really does have a very vital effect on trade.

Mr. BALE. And for that reason, Mr. Chairman, we are thankful to have an outstanding Treasury Department to rely on for some of the important analysis in that area.

Senator MATHIAS. A very politic closing statement. [Laughter.]

Thank you both for appearing here today.

We will now have several panels. The first panel will be Mr. Kenneth Cory, controller of the State of California; Mr. Owen L. Clarke of the National Association of Tax Administrators; Mr. Robert Dillon, senior vice president of the Financial Division of Sony; Mr. James K. Caudill, tax counsel for BATUS, Inc. of Louisville, KY; and the Honorable David Nething, majority leader of the senate of North Dakota.

Gentlemen, as you are all very well aware, at our backs we always hear time's winged chariot hovering near. If we are to get through all the witnesses here, I am wondering if I could have your cooperation in limiting your statements to 5 minutes each and, of course, your written statements will appear in the record.

Do you have any preferences as to who begins, or should we start with Mr. Cory since we started the list with him?

STATEMENT OF KENNETH CORY, CONTROLLER, STATE OF CALIFORNIA, SACRAMENTO, CA

Mr. CORY. Thank you, Mr. Chairman.

I am Ken Cory, the controller of the State of California. I appreciate the opportunity to be here though I guess I represent the Grinch that stole Christmas in terms of the subject matter. I am appearing here before you on behalf of Kent Conrad, past chairman of the Multistate Tax Compact Commission, and also in my capacity as controller of the State of California, as a member of the franchise tax board, and chairman thereof, and as a member of the State board of equalization.

To place myself in perspective, I should advise you that I am a statewide elected public official in California.

Senator MATHIAS. I am well aware of that. I am well aware of the fact that the office of controller is a kind of launching pad. Your predecessor, the Senator from California, Mr. Cranston, is a member of this committee.

Mr. CORY. And we also had a gentleman who is a member of your body, Senator Tom Kuchel, who was also a previous controller.

Senator MATHIAS. A distinguished member of this body.

Mr. CORY. To put somewhat in perspective what I say, with the appropriate grain of salt, I also spent four terms in the California Legislature. I represented Disneyland, Knott's Berry Farm, and other bastions of liberalism in Orange County. [Laughter.]

I happen to be a Democrat, so if you can figure how all that works together, I would appreciate it if you could tell me at the conclusion of this hearing so that I could give better answers to some of the questions I am asked.

Senator MATHIAS. Sometimes it is better not to know. [Laughter.]

Mr. CORY. That is perhaps how I have gotten this far.

Senator MATHIAS. Believing where we cannot prove.

Mr. CORY. I would like to state that the commission and its member States are opposed to any Federal legislation which would restrict the rights of individual States to establish their own tax policy. Putting that in perspective, I would like to share with you a brief quote that now President Reagan, when he was Governor of the State of California, wrote in a letter, oddly enough, to then-Senator Mondale. This was in 1973.

He said: "One of the great strengths of our federal-state system is the freedom of states to act to meet their own particular problems in ways that seem best to them. Interference by the federal government with the states' power to tax would be a major blow to such freedom." He went on to conclude that "Federal intervention in the interstate taxation field is both undesirable and dangerous and should only be considered as a last resort."

Being an Orange County Democrat I would just like to leave that on the record because I think that is probably the last public statement that we have been able to find of President Reagan in this matter.

I would like to tell you that I believe very strongly——

Senator MATHIAS. Let me just ask you is Disneyland in Orange County?

Mr. CORY. Yes, it is.

Senator MATHIAS. I thought so.

Mr. CORY. So is Knott's Berry Farm.

Senator MATHIAS. I am corrected by Senator Hawkins.

Senator HAWKINS. Disney World is in Orange County, but there is Disneyland——

Mr. CORY. And I am very proud not only to have represented it, but to have also been the first lifeguard at the hotel when they opened. So I have very fond memories of Disneyland in my youth.

Senator MATHIAS. Maybe that is the explanation for these events that you cannot otherwise explain. [Laughter.]

Mr. CORY. I would like to point out that I have, in the past, and am today, a proponent of the unitary accounting principle as being a valid method of allocating taxes throughout a multiplicity of jurisdictions. With regard to the arm's length standard which many of the business communities think is a worthwhile program, I would suggest they review the abuses that have been brought to my attention in California.

I will concede, however, that there have been abuses in California's application of the unitary accounting principle. But those same abuses could also occur by an overzealous auditor using the arm's length transaction. I would suggest to you that the arm's length standard is far more subject to those kinds of abuses than is the unitary accounting principle.

That is a personal policy decision that I doubt we will ever agree upon, and we will only know who is right if we go to a full-scale implementation of the unitary method, but it does get to the point of the Working Group's recommendation that additional Federal help is needed for the States to implement the arm's length standard. This is one of the serious questions that I think has to be put on the table.

I would like to report, in spite of the differences of opinion as to what might be best, that as shown by actions in the State of Oregon, and the serious consideration given legislation proposed by the Working Group in the State of California, that the process of resolution is under way and that the dialog can take place.

We also have in California, under the existing law, a procedure under our Revenue and Taxation Code section 25137, which enables people who feel that the unitary accounting principle somehow distorts the true value and amount of taxes that are being allocated to seek redress. They can petition and ask for a hearing. We have considered 28 such petitions in California. They have all been considered somewhat recent.

Many of the business community have been looking for judicial solutions to their tax problems, rather than the section 25137 hearings. I am hopeful that more of the corporations will avail themselves of those hearings in the future.

I would also like to point out that I, as a supporter of the unitary method, extended an olive branch, if you will, to the corporate community and suggested legislation which would exempt new plants from the unitary accounting principle. That was not accepted by the legislature.

The Governor put forth his program, which is a water's edge proposal. It is important to realize that that program, although supported by our Governor, is a moderate proposal, one I did not support, but one that got some motion going in California. But it died because domestic multinational corporations disfavored it. They basically killed it.

So what I really want to leave you with is that there are changes. There are opportunities for change. There is a decision-making process at the State level that is trying to accommodate these needs and these concerns, and I think if it is left unfettered that it can bear fruit.

Thank you, Mr. Chairman.

[Mr. Cory's prepared statement follows:]

PREPARED STATEMENT OF KENNETH CORY

The Multistate Tax Commission is the administrative arm of the Multistate Tax Compact, a joint effort by 21 full member states and 10 associate member states to promote uniform and equitable state tax administration. The Multistate Tax Commission participated in the President's Worldwide Unity Taxation Working Group study along with representatives of several of its member states, including Governors Deukmejian of California and Mathesen of Utah.

It must be made clear that the Commission and its member states remain unalterably opposed to any federal legislation which would restrict the rights of individual states to establish their own tax policies. In 1973, President Reagan, while he was Governor of California, in a letter (Attached as Exhibit A.) to then Senator Mondale, wrote:

One of the great strengths of our federal-state system is the freedom of the states to act to meet their own particular problems in the ways that seem best to them. Interference by the federal government with the states' power to tax would be a major blow to such freedom.

* * *

Federal intervention in the interstate taxation field is both undesirable and dangerous and should only be considered as a last resort.

Federal intervention in state tax policy remains as "undesirable and dangerous" today as it was eleven years ago or one hundred ninety years ago.

The question of the use by the states of the worldwide combined report method has been the subject of extensive study over the last several years. In March of 1983, the Advisory Commission on Intergovernmental Relations issued a report on "State Taxation of Multinational Corporations." (Attached as Exhibit B.) This report recommended that no law be passed by Congress which would limit state tax practices with respect to multinational corporations because there was no evidence that "serious national harm" resulted from current state practices.

As Senator Mathias noted in his invitation to testify before this Subcommittee, the President's Worldwide Unitary Taxation Working Group has only recently concluded its efforts and issued its report. We believe all representatives of state interests entered the Working Group deliberations with the precepts and standards of the ACIR Report in mind. One of the first decisions made by the Working Group was a directive to its Task Force to consider only solutions which did not involve prescriptive federal legislation. And the Working Group concluded its deliberations with recommendations involving only voluntary modifications in the tax policies of certain states.

All members of the Working Group realized that voluntary state action could not be taken overnight, that the process of revising state tax policies would take time, but that nonetheless, state action was the appropriate solution.

It was, therefore, with great dismay that the state representatives received Secretary Regan's report of July 31, 1984, in which he indicated that federal legislation would be recommended to the President unless the states acted to resolve the matter by July 31, 1985. As the state members of the Working Group stated,

Such a new and unnecessary deadline ignores the fact that legislative and executive action by both the federal and state governments may well require more than eleven months to complete. Moreover, this recommendation is at odds with the Working Group's decision that water's edge combination, in the words of the Chairman's Report, "would be implemented by the states' action rather than by federal restrictions."

This does not, however, mean that federal legislation assisting the states is inappropriate as part of the Working Group process. The state representatives agreed that receding from worldwide combination would be appropriate state tax policy provided that federal action would be taken:

- o to require the filing of a domestic disclosure spreadsheet by all large corporations;
- o to provide funding for an audit referral agency to assist the states in using the information provided on the domestic disclosure spreadsheet;
- o to increase information sharing, not only between the federal government and the states but also with any common agency designated by the states for this purpose;

- o to triple the amount of federal revenues directed to arm's-length audit activities (It should be noted that this number was not pulled out of the air, but was based upon recommendations by the technical staff of the Internal Revenue Service as to the resources required to provide full coverage under the current rules and procedures utilized by the IRS in auditing international transactions.); and
- o to establish a threshold level of sales in Public Law 86-272 to allow states to assert jurisdiction over out-of-state corporations.

All five of these steps were agreed to by Treasury representatives and all but the last was agreed to by corporate representatives to the Working Group.

The Multistate Tax Commission and the other state representatives to the Working Group believe that modification of state tax policy with regard to the worldwide combined report method can only be considered if these legislative steps are taken by the federal government, in conjunction with other federal administrative actions, to ensure complete audits and full state access to the information necessary to fairly and completely audit all corporate taxpayers.

The issue of worldwide combined reporting is significant to the states not only philosophically but also from a revenue standpoint. Studies by the Internal Revenue Service (and by the individual states) during the Task Force deliberations of the Working Group process verify the magnitude of the losses involved. While the Working Group recommendations provide safeguards in terms of defining the water's edge limits and increased federal assistance, the revenue estimates are still in the hundreds of millions of dollars. The more restrictive state tax policies suggested by the corporate representatives and embodied in current federal proposals would be several times more costly.

State tax policies are subject to the competitive forces induced by our federal system. If a state's tax policies are significantly out of line with those practiced by other states, it will lose business investment opportunities. Whether such opportunities have in fact been lost to an individual state as a result of its use of the worldwide combined report method is virtually impossible to determine.

California has utilized the worldwide unitary method for over twenty years. It was also one of the first states to serve as a significant foreign market and to receive significant foreign investment. This process started in the sixties and continues today. California is always among the state leaders in attracting foreign investment and in most years it has been the leading state by significant margins. For example, fifteen years ago the eleven largest California banks were domestically owned. Now seven of the eleven are foreign owned. Foreign business presence in California has been a significant part of our economy for years, and I believe it will continue to be so.

Recent actions by the State of Oregon, and inaction by California on the unitary question, have been credited with causing the loss of a Japanese investment in California. This is a highly subjective judgment. There are objective economic statistics, however, which suggest that the use of the unitary method on a worldwide basis has not hurt the economies of the states which use it or impaired their attractiveness as investment locations.

- o California, commonly identified as the most aggressive proponent and practitioner of the worldwide unitary method, led the nation in 1983 in job expansions.
- o Bureau of Labor statistics for June of 1984 show that three of the six states (Massachusetts, New Hampshire and North Dakota) with the lowest level of unemployment are worldwide unitary states.
- o Four of the top ten job markets in the United States are in California according to Chase Econometrics.
- o California is the leading foreign export state in the country.
- o Three of the top ten business climate states (Florida, North Dakota and Utah) are worldwide unitary states.

Florida's ability to maintain its 1982 ranking as the number one business climate state in the country in 1983 is particularly revealing because of its adoption of the worldwide unitary method in June of 1983 and business statements immediately afterwards that this action had moved it from the best to the worst business climate state.

Whether the use of the worldwide unitary is an actual disincentive for investment may never be known. However, it is clear that interstate competition fostered by our federal system is real and will resolve the problems, whether real or imaginary, presented by the worldwide use of the unitary method. The action recently taken by Oregon and the serious consideration given to legislation based on the Working Group Report by California and Florida shows that the process of resolution has begun and provides evidence that federal action is unnecessary. Given the revenue considerations involved, however the states must be given the necessary time to redesign their internal policy and balance competing interests.

The Working Group recommendations are in the best traditions of our federalist system of government. They propose voluntary state actions in an area which is of preeminent state concern. The recommendations address the concerns of our foreign trading partners and foreign multinationals. The opposition which is raised by domestic multinationals to the California legislative proposals and the Working Group recommendations has nothing to do with the concerns of our foreign trading partners. Efforts by the domestic multinationals to hold both state and federal initiatives hostage to their own concerns with state tax policies should not be considered.

[Exhibit A]

STATE OF CALIFORNIA,
GOVERNOR'S OFFICE,
Sacramento, September 14, 1973.

Hon. WALTER F. MONDALE,
U.S. Senate, Chairman, Senate Finance Subcommittee on State Taxation of Interstate
Commerce, Washington, DC.

DEAR SENATOR MONDALE: I concur with your view that any federal legislation in the area of state taxation of interstate commerce should have the support of a consensus on the part of the states and acceptance by the business community.

One of the great strengths of our federal-state system is the freedom of the states to act to meet their own particular problems in the ways that seem best to them. Interference by the federal government with the states' power to tax would be a major blow to such freedom.

While there have been some representations that there is a general agreement, a close look will reveal that there are very important areas of controversy between the states and the business community. S. 1245, for example, sets up an unacceptable rule as to organizations doing business in multicorporate form. The adoption of this bill would result in revenue losses to California of up to \$100 million a year. Such losses would inevitably have to be shifted to other taxpayers.

California is making every possible effort to cooperate with other states in the development of uniform rules and procedures. I believe any objective review of the past ten years will show that substantial progress has been made. This should be allowed to continue.

There is no question but that the states need constant pressure if they are to continue their progress toward greater equity and uniformity. The most constructive action that could be taken by the Congress would be to provide an oversight function with check points at reasonable intervals, such as every five years.

Federal intervention in the interstate taxation field is both undesirable and dangerous and should only be considered as a last resort.

Sincerely,

RONALD REAGAN,
Governor.

[Exhibit B]

STATE TAXATION OF MULTINATIONAL CORPORATIONS

Set forth below is the full text of a March 1983 report by the Advisory Commission on Intergovernmental Relations (ACIR) which seeks to break new ground in dealing with the issues presented by the continuing dispute over state use of the unitary method of taxation. The appendixes to the ACIR report are not reproduced here. The full text of the report has been placed in the March 14, 1983 Tax Notes Microfiche Data Base as Doc. 83-2199.

PREFACE

Conflict exists between state and national rules for taxing multinational corporations. Several states use the worldwide combination approach for determining the taxable income of multinational firms. In the past, the Treasury Department has taken the position that these state practices do not conform to internationally accepted standards which are based on separately accounting for the income of corporations located in each country. It followed, then, that these state tax practices worked against a national interest—international tax harmonization.

For students of our federal system this conflict between national and state interests has far-reaching implications. It forces policymakers to balance two equally important constitutional concerns: promoting the free flow of foreign and domestic commerce, and granting states wide leeway in charting their own tax policies.

This report attempts to break new ground in this contentious field. It develops a "serious national harm" test to determine when the state concern for tax sovereignty should give way to the national interest in harmonizing international tax practices.

After examining the relevant documentation and consulting with knowledgeable practitioners, the Commission staff could find no evidence of harm to the nation

caused by the fact that state taxing practices were not in harmony with generally accepted international practices.

This study also points up that two self-correcting forces—interstate tax competition and the courts—should prevent state tax practices from causing serious national harm in the foreseeable future. Therefore, the Commission recommends that the Congress pass no law to limit state tax practices with respect to multinational corporations or "foreign source" income.

ROBERT B. HAWKINS,
Chairman.

ACKNOWLEDGMENTS

Harvey Galper, a former Senior Resident at the Advisory Commission on Intergovernmental Relations, was the principal author of this report, which built on an earlier study done by Professor Kenneth Ainsworth, also a Senior Resident. Final revision³ and publication details were shepherded by Senior Analyst Susannah Calkins.

Thanks are due to many persons outside the ACIR who read and commented on the report.

Ruth Phillips typed the report and provided other assistance.

S. KENNETH HOWARD,
Executive Director.

JOHN SHANNON,
Assistant Director, Taxation and Finance.

INTRODUCTION

Differences between state and national rules for taxing multinational corporations have always been a potential source of conflict in the federal system. However, in recent years, the problems that can result when each state and the national government apply different rules for taxing income arising from international commerce have been accorded increasing prominence due to court decisions, state legislative actions, deliberations on international tax treaties, and proposed national legislation.

The Senate debate on the United States-United Kingdom tax treaty during the period 1977-1979 illustrates the conflict. The controversial article 9(4) of the proposed U.K. treaty would have prohibited state tax practices that defined as unitary businesses the combination of U.K. parent corporations and U.S. subsidiaries and then apportioned a share of the worldwide income thus derived to individual states to be subject to state corporate income taxes.

The Treasury Department claimed during the debate that this prohibition on state tax practices was required to conform state law to internationally-accepted standards that are based on separately accounting for the income of corporations located in each country. The states opposing this prohibition made several counter-claims. At one level, they argued that separate accounting, which requires that all transactions between affiliated corporations be calculated on an arm's length basis, is virtually impossible to administer and is not an appropriate mechanism for distinguishing domestic from foreign source income in today's world of highly interconnected corporations operating under common management and control. In addition, they took the position that the proposed prohibition was an unwarranted attack on state sovereignty in the field of taxation.

The central questions in this debate were: what are the national and state interests in the taxation of multinational corporations and how can they be reconciled? Although the controversial restriction on state taxation was deleted in the final version of the U.S.-U.K. Treaty, the questions raised above have not yet been satisfactorily answered. In fact, some observers considered the treaty negotiating process an inappropriate forum for resolving a major intergovernmental tax policy issue. For example, Ferdinand Schoettle, Professor of Law at the University of Minnesota Law School and a student of state taxation, thought it:

"Very unwise for the Treasury to allow federal policy to be dictated by the exigencies of a treaty negotiation. State taxation of United Kingdom income is relatively unimportant. However, the future use by the states of the unitary business doctrine is one of the more important issues concerning state taxation of interstate business that has to be resolved."¹

¹ Ferdinand P. Schoettle, "The U.K. Treaty and the State Taxation of Corporation Income." *Tax Notes*, Vol. 5, No. 14, April 4, 1977, p. 4.

THE COMPETING NATIONAL AND STATE INTERESTS

This section will outline the national and state interests in state taxation of multinational corporations. The appropriate treatment of such state taxation will thus be seen to require the accommodation of competing state and national interests. The national interest can be viewed from the perspectives of constitutional jurisprudence, congressional concerns, and the network of bilateral treaties with other countries around the world.

At the outset, it should be noted that the authority of Congress to legislate a uniform set of rules for states to follow in international tax policy is unquestioned. The Constitution empowers Congress "to regulate commerce with foreign nations" (Article I, section 8, clause 3) and even forbids the states from making separate arrangements with foreign governments (Article I, section 10, clause 1).

In Federalist 42, Madison provides further elaboration on this subject:

"The second class of powers lodged in the general government consist of those which regulate the intercourse with foreign nations . . . This class of powers forms an obvious and essential branch of the federal administration. If we are to be one nation in any respect, it clearly ought to be in respect to other nations."²

The national interest

Constitutional Issue. In constitutional terms the national interest in state taxation of interstate and foreign commerce has three elements: (1) to assure that excessive state taxation does not impede the free flow of commerce among the states (the interstate commerce clause); (2) to assure that strictly lawful procedures are followed by the states (the due process clause of the 14th amendment), and (3) to assure that states do not infringe upon the authority of the nation to regulate commerce with foreign nations (the foreign commerce clause).

The national concerns about preserving due process and maintaining a free flow of interstate commerce have been interpreted quite similarly by the Supreme Court. Commerce clause standards, however, are somewhat more comprehensive.³ Here the landmark case is *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), which provided some measure of needed uniformity and consistency to commerce clause jurisprudence by overruling a prior court decision that looked more to the language of state tax law than to its substantive effects.⁴ In *Complete Auto Transit*, the court set forth a four-part test, providing that a state tax will pass constitutional muster if it is "applied to an activity with a substantial nexus within the taxing state, is fairly apportioned, does not discriminate against commerce and is fairly related to the services provided by the state."⁵ In other words, "interstate commerce must bear its fair share of the state tax burden."⁶

In the strictly domestic context, a fair apportionment method has not been a major source of conflict between state and national interests, although by no means have all the issues of state taxation of interstate commerce been resolved.⁷

In the international sphere, however, differences between national and state interests have become quite contentious. It is also in the international arena where the constitutional tests for permissible state taxation appear to be more rigorous. In addition to the four tests in *Complete Auto Transit*—nexus, apportionment, nondiscrimination, and a fair relation to services provided—the Court noted in *Japan Line* that a tax on the "instrumentalities of foreign commerce" must take account of two

² *The Federalist Papers*, New York, The New American Library, 1961, p. 264.

³ Of the four tests discussed below in the text, the first two are required for satisfying the due process clause. For example, in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207, 219-220 (1980), the court stated that "state taxation required a 'minimal connection' or 'nexus' between the interstate activities and the taxing state and 'a rational relationship between the income attributed to the state and the intrastate values of the enterprise,'" quoting *Mobil Oil Corp. vs. Commissioner of Taxes of Vermont*, 445 U.S. 425, 436.

⁴ The case overruled was *Spector Motor Service Inc. v. O'Connor*, 340 U.S. 602 (1951).

⁵ 430 U.S. 274, 279.

⁶ *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 444 (1979) quoting *Washington Revenue Dept. v. Association of Washington Stevedoring Companies*, 435 U.S. 734, 750 (1978).

⁷ The major remaining controversy in the domestic area surrounds the question of what constitutes a unitary business operation. See Comptroller General of the United States. Report to the Chairman of the House Committee on Ways and Means. *Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving* (GGD-82-38), Washington, D.C., U.S. General Accounting Office, July 1, 1982. The 45 states (including the District of Columbia) which levy a corporate income tax differ in the rules regarding jurisdiction to tax, apportionment formulas, the allocation of income items that are not apportioned by formula, and the use of combined reporting.

"additional considerations."⁸ "The first is the enhanced risk of multiple taxation"⁹ that may result from the simultaneous application of state taxes and taxes imposed by a foreign government. "Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential."¹⁰ This latter point was elaborated in the Court's reference to its earlier statement in *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976), that "the federal government must speak with one voice when regulating commercial relations with foreign governments."¹¹ In the case of foreign commerce, then, state taxation may have a higher barrier to overcome to be judged constitutionally acceptable.

Congressional Response. From the congressional perspective, expressions of concern began with the Willis Report, named for the chairman of the Subcommittee of the House Judiciary Committee and released as a four-volume study in 1964 and 1965 entitled "*State Taxation of Interstate Commerce*."¹² This report stated:

"In keeping with the basic structure of our federal system, the committee is of the view that international tax policy should be formulated by the federal government and not by individual states. Therefore, with respect to income earned by corporations which operate either wholly or partially outside of the United States, the committee recommends that state apportionment rules be required to conform to the international policies that have been formulated for federal income tax purposes."¹³

Later, in 1976, the House Ways and Means Committee appointed a special task force on foreign source income headed by Congressman Rostenkowski to study this issue. In a report filed in 1977, the task force recommended that federal income tax rules apply to state taxation of foreign source income.¹⁴ Legislation has been introduced almost annually since 1965 to conform state and federal practices, most recently as H.R. 5076 and S. 1688 in the 96th Congress and H.R. 1983 and S. 655 in the 97th Congress.

Tax Treaties. With respect to this country's tax treaty network, the very existence of some 30 independently negotiated income tax treaties bespeaks a strong national interest in international tax harmonization to promote an efficient flow of international trade and investment. In testimony before the Foreign Relations Committee of the United States Senate, the late Laurence Woodworth, then Assistant Secretary of the Treasury for Tax Policy, articulated this national interest.

"We view tax treaties as an important element in the international economic policy of the United States. One of our fundamental objectives is to minimize impediments to free international flows of capital and technology, and this objective is fostered by having the broadest possible network of income tax treaties.

"Among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries. Tax treaties seek to eliminate, or at least mitigate the impact of, these impediments.

"Treaties accomplish this minimization of impediments by a variety of means, the principal ones being the elimination or reduction of double taxation and the elimination, to the extent possible, of discriminatory tax rules which distinguish unreasonably between domestic and foreign investment.

"At the same time, tax treaties also serve other policy objectives—for example, the prevention of tax avoidance and evasion, and the fostering of international cooperation between the tax authorities of Contracting States."¹⁵

Benefits of Tax Harmonization. The stakes in tax harmonization, or coordination of the tax systems of various countries, involve more than a desire for orderliness in international tax matters. Without such harmonization, double taxation of income could easily occur, resulting in a loss of international investment and income flows. In 1981, U.S. firms' direct investments abroad increased by \$11.8 billion to a level of

⁸ 441 U.S. 434, 445.

⁹ *Ibid.*

¹⁰ *Ibid.*, 448.

¹¹ *Ibid.*, 449, quoting 423 U.S. 276, 285.

¹² Published as H. Rept. No. 1480, 88th Congress, 2nd Session, June 15, 1964; H. Rept. No. 565, 89th Congress, First Session, June 30, 1965, and H. Rept. No. 952, 89th Congress, First Session, September 2, 1965, Washington, D.C., U.S. Government Printing Office, 1964 and 1965.

¹³ *Ibid.*, H. Rept. 952, p. 1155.

¹⁴ House Committee on Ways and Means, *Recommendations of the Task Force on Foreign Source Income*. Washington, D.C., U.S. Government Printing Office, 1977, p. 30.

¹⁵ Statement of Assistant Secretary of the Treasury, Laurence N. Woodworth, before the Senate Committee on Foreign Relations, *Hearings on Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines*, July 19 and 20, 1977, 95th Congress, First Session, Washington, D.C., U.S. Government Printing Office, 1977, p. 28.

\$227.3 billion, and these firms received 1981 incomes of \$31.9 billion from this cumulative direct foreign investment. That same year, foreign firms' direct investment in the U.S. increased by \$21.3 billion to a level of \$89.6 billion, and these firms received 1981 income of \$7.8 billion from this cumulative investment.¹⁶

These capital investments and income flows contribute significantly to increasing worldwide standards of living. The capital importing or host country benefits from the use of foreign capital in its production processes because the resulting higher capital-to-labor ratios can increase productivity and raise real earnings. The capital exporting country benefits from the rate of return that can be earned on capital employed abroad. Excessive taxation of the income generated from foreign investments through failure to harmonize national tax systems could undermine this beneficial flow of capital.

International tax harmonization is not dissimilar to arrangements that states have worked out for taxing the income of people working in one state and living in a neighboring one. If the state of employment asserts its right to tax income on a source or where-earned basis, the state of residence generally allows the employee a credit against its own tax levied on a residence basis. Thus, at the state level, double taxation of the same income is eliminated. At the same time, individual households benefit because their choices of work places and residences are not restricted by tax considerations. Similar benefits to U.S. citizens occur through tax harmonization on an international level.

International tax harmonization, however, cannot occur without an internationally accepted set of standards that can serve as the foundation for all tax treaty negotiations.

Internationally Accepted Standards. Internationally accepted standards establish principles for taxing foreign-owned enterprises operating in the United States and U.S. owned enterprises operating abroad. Two important sets of rules for this purpose are: (1) those defining a *permanent establishment*, such as a branch or subsidiary corporation, that can be taxed by the host country; and (2) those specifying the procedures to be used to account for transactions between related parties in measuring the income of a permanent establishment. Under these latter rules, the permanent establishment is to be regarded as a *separate entity* and transactions between related parties are calculated on an *arm's length basis*, that is, as if the related parties were dealing with each other as independent enterprises at arm's length.

These standards have evolved from about 50 years of effort on the part of both technical experts and tax treaty negotiators.¹⁷ The Organization for Economic Cooperation and Development (OECD) treaty, most recently revised in 1977, and the United States model income tax treaty, last issued in June 1981, reflect a "water's edge" rule. Permanent establishments in foreign countries are considered separate entities. Even if transactions occur between related foreign and domestic corporations, the income attributable to the foreign entity is calculated by reference to transactions *between independent parties*.¹⁸

Conflicts With State Practice. These water's edge rules contrast sharply with the procedures used by 12 states that apply a unitary apportionment approach to worldwide combinations of affiliated firms. Under this approach, income from all firms believed to be part of a unitary business enterprise—whether domestic or foreign firms—is added together to determine the combined income of the entire enterprise. The share of this combined income attributable to a particular state is measured by taking the ratios of the in-state values of the standard apportionment factors—sales, property, and payroll—to their worldwide values.

The Treasury Department, during the Carter Administration, took the position that the conflict between state use of worldwide combination and apportionment

¹⁶ Direct investment excludes investment in bonds, notes or so-called "portfolio" stock investments through which no controlling interest is obtained. See Obie G. Whichard, "U.S. Direct Investment Abroad in 1981," and Ned G. Howenstine and Gregory G. Fouch, "Foreign Direct Investment in the United States in 1981," both in U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, Vol. 62, No. 8, August 1982. The figures appear in Table 1, p. 12; Table 8, p. 17; Table 1, p. 31; Table 6, p. 34.

¹⁷ Statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury, before the Subcommittee on Oversight, House Committee on Ways and Means, *Hearings on Income Tax Treaties*, April 29, 1980, 96th Congress, 2nd Session. Washington, D.C., U.S. Government Printing Office, 1980, p. 61.

¹⁸ The United States takes residents on worldwide income—from both domestic and foreign sources. Double taxation is eliminated, however, by providing a credit for foreign taxes on foreign-source income. Hence, there is still a need to determine foreign-source income from establishments located abroad to calculate the allowable foreign tax credit, and this is where the federal government uses the water's edge rule to avoid double taxation of foreign source income.

practices and the water's edge rules used by the U.S. government and in international practice can have serious implications. First, as noted, it can interfere with national tax harmonization objectives.

Second, conflict between national and state rules can be a substantial irritant in international tax and trade policy. A number of foreign governments have transmitted to the United States their formal objections to the states' using worldwide combination rules for taxing corporations owned by citizens in their countries. Belgium, Canada, France, Italy, the United Kingdom, and the nine governments of the European Economic Community (EEC), among others, have voiced such objections.¹⁹

Also, testimony during Senate consideration of the U.K. treaty offered several examples of taxpayer objections to worldwide combination practices.²⁰ Although the facts of these cases are undoubtedly subject to dispute and the testimony displays states in the worst possible light, there is legitimate concern about the potential for interference with the free flow of international commerce.²¹

The federal government is also concerned that foreign governments, wanting to help their own corporate taxpayers, could retaliate against the United States. Countries believe the unitary approach as applied to worldwide combinations imposes inequitable state tax burdens on foreign-owned corporations and entails state taxation of out-of-state, or extraterritorial values. The countries could, therefore, conclude that some appropriate response is required to demonstrate their concern. U.S. corporations with subsidiaries located abroad could be targets.

However, a more likely result of continuing foreign governments' concern with the state unitary taxation would be the inability of the United States to negotiate tax treaties on as favorable terms to American multinational corporations as could otherwise be achieved. Although the exact way that any particular issue enters into a complex treaty negotiation is difficult to determine, state action would have the effect of restricting federal flexibility in ongoing treaty negotiations.

The State interest

Against this national interest must be set the states' interest in continued use of worldwide combined reporting.

History. First, a brief history of state use of formula apportionment may be instructive. In the early days of state income taxation, separate accounting was considered the preferred approach for determining within state income of a multistate firm, even though implementation of this approach required detailed records for calculating income on either a functional or a geographical basis.²² Formula apportionment came to be applied to the activity of a single multistate firm as a practical solution to the need for a workable and inexpensive dividing-up rule, that is to say, "out of sheer necessity."²³ The technique was first used to apportion intangible property values—such as good will—for railroads operating across state lines by employing such crude devices as the number of track miles of railroad property in each state. Eventually, the technique evolved into the apportionment of income by factors believed to give rise to that income. It was also a small step from apportioning the income of a single firm among the several states in which it operated to apportioning the combined income of a group or related firms deemed to be operating as a single unitary business. And also, in the view of many states, it was not a much larger step to view affiliated firms operating worldwide in the same way as such firms engaged in solely domestic activity. From the states' perspective unitary apportionment on either a domestic or a worldwide basis is but a logical corollary of the growing complexity of contemporary corporate financial arrangements. The same motive "of sheer necessity" that impelled states to replace the early unworkable separate accounting scheme for determining the income of a single multistate firm is operative today.

¹⁹ Examples of the statements of foreign countries are reproduced in Appendix A to the ACIR memo on which this article is based. That Appendix is omitted here. (Ed.)

²⁰ It should be noted, however, that not all corporations offered objection to worldwide combination. The Caterpillar Corporation, for example, favored that approach.

²¹ See, for example, the testimony of Valentine Brookes before the Senate Committee on Foreign Relations, *Hearings on Tax Treaties with the United Kingdom*, op. cit., pp. 212-221, and the testimony of William D. McKee, pp. 291-5.

²² See Jerome R. Hellerstein, "The Unitary Business Principle and Multicorporate Enterprises: An Examination of the Major Controversies," *Tax Executive*, July 1975, p. 314; and Jerome R. and Walter Hellerstein, *State and Local Taxation*, 4th edition, St. Paul, Minn., West Publishing Co., 1978, pp. 432-433.

²³ Proponents of worldwide combined reporting also point up theoretical advantages, i.e., accounting for intangible factors such as good will and management strength.

State Argument for Continued Use of Unitary Principles. The position of the states regarding the continued use of worldwide unitary combination procedures may be found in the statements of numerous revenue officers, other state officials, state organizations (such as the National Governors' Association and the National Association of Tax Administrators), and the Multistate Tax Commission—a compact of 20 states.²⁴ The states make several general arguments in support of using worldwide combination.

1. Revenue Losses. At the most pragmatic level, states are concerned about the revenue losses that would result if they were prohibited from applying unitary principles on a worldwide basis. For example, the Multistate Tax Commission estimates that legislation before the 97th Congress²⁵ disallowing both worldwide combination procedures and the state taxation of foreign source dividends would involve revenue losses to the states of over \$700 million or over 6 percent of total state collections from corporate income taxes in 1981.²⁶ At a time of increased fiscal responsibilities, cutbacks of federal grants-in-aid, and limitations on their abilities to raise revenues from other sources, states feel genuinely aggrieved by the prospect of significant revenue losses.²⁷

2. Administrability of Separate Accounting. It is also contended that another consideration is relative difficulty in administering separate compared to unitary accounting.²⁸ States claim that separate accounting is an unworkable device for distinguishing between domestic and foreign source income and that only worldwide apportionment can effectively deal with the income measurement problems arising from transactions between related corporations. An article on separate accounting in the 1976 Harvard Law Review suggested that multinational corporations (MNCs) have considerable flexibility in shifting income among countries due to the rules they use for pricing transfers between affiliated firms.

"While tax avoidance may enter into a MNC's determination of transfer prices, there are many important non-income tax influences on such decisions. Whatever the motivation, however, freely established transfer pricing represents a means whereby MNC profits produced by subsidiaries in countries with high tax burdens may be shifted to other entities subject to more favorable tax treatment. Whenever transfer pricing has the effect of shifting income in this way, a country in which

²⁴ The sources cited below are illustrative rather than exhaustive. Numerous other examples could have been selected.

²⁵ The legislation is H.R. 1983 and S. 655, 97th Congress, 2nd Session.

²⁶ These revenue loss estimates are reported in Multistate Tax Commission, "Summary of State Responses to Treasury Department Questionnaire on Use of Unitary Method and Taxation of Dividend Income," (unpublished response to Treasury Department Survey, May 11, 1982), p. 12, cited in *Tax Notes*, 15, No. 8 (May 24, 1982), p. 696. Collections from state corporate taxes in 1981 were \$14.1 billion dollars, according to the Bureau of the Census. These estimates of revenue loss have not been accepted in all quarters. The Committee on State Taxation of the Council of State Chambers of Commerce has estimated revenue losses of under \$100 million. See Committee on State Taxation, "Revenue Impact on States of H.R. 5076," Press release date April 24, 1980.

²⁷ For examples of this argument see letter of December 30, 1981 from Governor Babbitt of Arizona to President Reagan on behalf of the Western Governors Policy Office (WESTPO) and enclosed WESTPO resolution of April 5-7, 1981; Ferdinand P. Schoettle, "The U.K. Treaty and the State Taxation of Corporate Income," *Tax Notes*, vol. 5, no. 14 (April 4, 1977), pp. 3-8; statement of William Craven, president, National Association of Tax Administrators and Director, Audit Division, Department of Taxation and Finance, State of New York including the position paper of the National Association of Tax Administrators on interstate taxation of business adopted June 10-13, 1979, in *State Taxation of Foreign Source Income*, Hearings on H.R. 5076, before the 96th Congress, 2nd Session, March 31, 1980, pp. 11-17. In this same hearing see also statements by the following: Byron Dorgan, past chairman, Multistate Tax Commission and Tax Commissioner, State of North Dakota, p. 19; Theodore W. de Looze, chief tax counsel, Department of Justice, State of Oregon, pp. 36 and 44; James E. Zagel, director, Department of Revenue, State of Illinois, p. 51; James Hamilton, assistant chief counsel, California State Franchise Tax Board, p. 56.

A more fundamental question, of course, is whether revenue consideration should play such a prominent role in the policy debate. In the words of Charles McLure, "One can, after all, think of many bad taxes that would raise substantial revenue." See his "Toward Uniformity in Interstate Taxation: A Further Analysis," *Tax Notes*, vol. 13, no. 2 (July 13, 1981), footnote 21, p. 55.

²⁸ For a discussion of this position, see letter of December 30, 1981, from Governor Babbitt, *op. cit.*; William D. Dexter, "An Analysis of and Comment on, H.R. 1983 and S. 655 of the 97th Congress," Multistate Tax Commission, processed, undated; Jerome R. Hellierstein, *op. cit.*, pp. 316-317, 319-320; National Association of Tax Administrators, Resolution No. 18, adopted at annual meeting, May 31-June 4, 1982, New Orleans, La., and the following statements in *State Taxation of Foreign Source Income*; William Craven, pp. 14-15; Byron Dorgan, pp. 21-22; Theodore W. de Looze, pp. 37, 42-43; James Hamilton, pp. 58-59, 62; and Ferdinand P. Schoettle, pp. 337-338.

economically significant activities took place is deprived of some portion of its fair share of the taxable income of the MNC."²⁹

The recently-issued report by the General Accounting Office on the Internal Revenue Service's administration of arm's length pricing rules under section 482 of the tax code supports this position.³⁰ The GAO report is highly critical of IRS enforcement procedures under section 482 and found that the IRS has been able to use a true arm's length standard in only a small minority of cases.³¹ Furthermore, the GAO recommends that serious attention be given to using worldwide combination and formula apportionment practices for measuring the income of multinational corporations.³²

3. State Sovereignty. On a philosophical level, the states argue that they should be able to determine their own fiscal structures without outside interference.³³ This traditional position against federal encroachment on state prerogatives is buttressed by the view that the authority to tax is critical to the very existence of states as constitutionally protected sovereign governments within the federal system. Therefore, doubts should be resolved in favor of wide leeway for state tax policymakers.

4. No Serious Demonstrated Harm. A less dogmatic interpretation of this federalism position is that there has been no demonstration of harm as a result of state taxation of multinational corporations, and, therefore, no compelling reasons to restrict state action.³⁴ Foreign corporations shall want to invest in the U.S.; foreign governments leave not tried to impose retaliatory taxation on U.S. corporations operating abroad; and foreign governments still wish to conclude tax and other treaties with the United States. In short, while acknowledging that foreign governments have formally objected to the use of worldwide apportionment procedures, the states claim that it has not been possible to marshal evidence of serious national harm resulting from state tax practices.

5. Adequate Judicial Remedies are Available. Other arguments against imposing restrictions on state taxing authority are based on the dynamics of the federal system and the tendency for excesses to be self-correcting in the absence of direct federal intervention. For example, the courts can insure that constitutional limitations on state taxing authority, as discussed above, are adhered to. Supreme Court decisions in *Japan Lines*³⁵ and more recently in *ASRRCO Inc. v. Idaho State Tax Commission*³⁶ and *F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*³⁷ are cited as positive examples.

The latter two cases *ASARCO* and *Woolworth* require further elaboration. In these two cases, the states of Idaho and New Mexico, respectively, wanted to include in the apportionable income of corporations doing business within their states dividend income received from subsidiary foreign corporations. The Supreme Court, relying on its position in *Mobil Oil Corp. v. The Commissioner of Taxes of Vermont* that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle,"³⁸ had to address the critical question of whether the payor corporations, in fact, had a unitary business relationship with the dividend receiving corporations. This question was decided affirmatively in *Mobil*, thereby giving Vermont the authority to tax foreign dividends received by a corporation doing business in the state. In *ASARCO* and *Woolworth*, the fact patterns led the Court to a difference conclusion, and on due process grounds, the Court rejected the right of Idaho and New Mexico to tax the foreign dividend receipts. In *ASARCO*, for example, the Court stated that "the record establishes that each of the three partial

²⁹ Multinational Corporation and Income Allocation Under Section 482 of the Internal Revenue Code," *Harvard Law Review*, Vol. 89, No. 6, April 1976, pp. 1203-1204.

³⁰ The Comptroller General of the United States, Report to the chairman of the House Committee on Ways and Means, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* (GGD-81-81), Washington, D.C., U.S. General Accounting Office, September 30, 1981.

³¹ *Ibid.*, p. 29.

³² *Ibid.*, p. 50-52.

³³ See Walter Hellerstein, "State Income Taxation of Multijurisdictional Corporations: Reflections on *Mobil*, *Exxon*, and H.R. 5076," *Michigan Law Review*, vol. 79, pp. 1 (November 1980), pp. 160, 169-170, and the following statements in *State Taxation of Foreign Source Income*: William Craven, pp. 11-17, Byron Dorgan, p. 18; and Theodore W. de Looze, p. 40.

³⁴ This view may be found in William D. Dexter, "Analysis of H.R. 1983 and S. 655", p. 21; Walter Hellerstein, "State Income Taxation of Multijurisdictional Corporations," pp. 159-160, and the following statements in *State Taxation of Foreign Source Income* Byron Dorgan, p. 18 and Theodore W. de Looze, pp. 41-42.

³⁵ 441 U.S. 434 (1979).

³⁶ 50 U.S. L.W. 4762 (U.S. 1982).

³⁷ 50 U.S. L.W. 4957 (U.S. 1982).

³⁸ 444 U.S. 425, 439 (1980).

subsidiaries in question operated a 'discrete business enterprise' having nothing to do with the activities of (ASARCO) in the taxing state'.³⁹ Idaho, therefore, could exercise no tax claim on the dividends received by ASARCO from these subsidiaries.

Additionally, in *Woolworth* the Court declared that the "gross up" element of foreign dividends to reflect foreign taxes deemed paid could not be taxed by New Mexico.⁴⁰

These decisions still leave unanswered questions. Perhaps most important is the exact contours of a constitutionally acceptable definition of a unitary business operation. In *ASARCO*, the Court struck down Idaho's contention that "corporate purpose should define unitary business,"⁴¹ declaring that "this definition of unitary business would destroy the concept."⁴² While no definitive guidelines were offered to the states, the Court suggested in *ASARCO* that in *Mobil* and *Exxon* "the states prevailed because it was clear that the affiliated corporations operated unitary businesses with a continuous flow and interchange of common products."⁴³ Furthermore, since no unitary relationship was found to have existed in *ASARCO* and *Woolworth*, no light has been shed on the question of whether state taxation on the basis of worldwide unitary combinations is itself unconstitutional.⁴⁴

The Supreme Court, in its current term, has the opportunity to decide this issue because it will be raised in both *Chicago Bridge and Iron* and also *Container Corporation of America v. Franchise Tax Board* (81-253).

The judicial process may move at a slow pace and not always provide conclusive answers, but there is no denying its role in the federal system in delimiting state tendencies toward an over-reaching tax system.⁴⁵

6. Self-Correcting Influence of State Competition. Another impetus for self-correction is the competition among the states for new industry, including firms that are affiliated with multinational groups. Some states, such as Virginia, have been revising their tax structures to be more congenial to multinational businesses. Evidence has also been cited of affiliates of foreign parents choosing to locate in states that are less aggressive in applying the unitary system on a worldwide basis.⁴⁶ In such a competitive environment, states will be constrained in setting up tax rules that are much out of step with sister states.

³⁹ 50 U.S. L.W. 4962, 4968 m. 24 (U.S. 1982), quoting *Mobil* U.S. 425, 442.

⁴⁰ This "gross up" element arises from provisions of national tax law explicitly designed to eliminate double taxation by the U.S. and foreign governments of the income from which foreign dividends are paid. The process entails three steps. First, cash dividends received by the domestic corporations are "grossed up" to reflect the foreign taxes paid on these dividends; next, the U.S. tax is assessed on the grossed-up dividends; then, a credit is allowed against the federal tax liability for foreign taxes deemed paid. In this way, foreign taxes reduce U.S. taxes dollar for dollar, and international double taxation is prevented.

⁴¹ 50 U.S. L.W. 4967.

⁴² *Ibid.*

⁴³ *Ibid.*, p. 4968, n. 24. A similar view was offered in *Woolworth* where "no flow of international business" was found, 50 U.S. L.W. 4957, 4961 (U.S. 1982).

⁴⁴ In his amicus brief in *Chicago Bridge and Iron Company v. Caterpillar Tractor Co.*, et al. no. 81-349, the Solicitor General contended that worldwide unitary combination for state tax purposes is unconstitutional because it prevents the national government from speaking with one voice on matters of international double taxation. It should also be noted that the Solicitor General has not resubmitted that amicus brief for consideration by the Supreme Court in the current term—a clear signal that the Reagan Administration no longer wants to be a party to any litigation designed to restrict state taxing powers. See Appendix B. That Appendix is omitted here. (Ed.)

⁴⁵ Some have expressed dissatisfaction with the case-by-case approach to dealing with policy issues involved in conflicts between federal and state tax practice, and have concluded that federal legislation is, therefore, needed. For example, the General Accounting Office in *Key Issues* . . . (page 22) commented that "although the Supreme Court has rendered decisions on some of the issues affecting state taxation of MJC's (multijurisdictional corporations), the inherent limitations of the judicial process have prevented and will continue to prevent the comprehensive treatment of the issues which their scope and complexity demand." Support for this view may be found in the cases in which the Supreme Court itself has invited Congress to act; for example, *Mooman Manufacturing Company v. Blair*, 437 U.S. 267, 280-1 (1978); *Washington Revenue Department v. Association of Washington Stevedoring Companies*, 435 U.S. 734, 749 (1978).

⁴⁶ See, for example, statement of Honorable Charles McC. Mathias, Jr., U.S. Senator from the State of Maryland in *State Taxation of Foreign Source Income*, op. cit., pp. 142-14; also the reply by the Committee on State Taxation (COST), Council of State Chambers of Commerce to a Treasury Department questionnaire, "Questions to COST Pertaining to S. 655 and H.R. 1983," June 10, 1982, pp. 16-18.

MAJOR FINDINGS AND CONCLUSIONS

1. Conflict has arisen between state and national rules for taxing multinational corporations. Several states have used the worldwide combination approach for determining the taxable income of multinational firms. During the Senate consideration of the U.K. Treaty, the Treasury Department took the position that these state practices did not conform to internationally accepted standards that are based on separately accounting for the income of corporations located in each country. Therefore, it was argued that these state tax practices worked against a national interest—international tax harmonization.

2. Conflicts between the interests of the national government and those of the states cannot easily be resolved without specific criteria or tests with which to evaluate the merits of the competing claims. In the present instance, either one of two tests can be applied to determine whether or not federal constraint of state authority to tax multinational corporations is appropriate.

3. The first test may be termed the *predominate national interest test*. Here, national intervention is appropriate if a state activity falls so clearly within the domain of the national interest that reasonable doubts must be resolved in favor of action by the national government. It is not necessary under this test to show that the nation has been seriously harmed by the failure of the national government to act, but only that the national government must be free to pursue the national interest (i.e., international tax harmonization) without hindrance or obstruction by the states. Where the national interest can be identified as predominant, state interests must give way "beyond the water's edge."

4. A second and far more stringent alternative test for justifying federal intervention is the *serious national harm test*. Here, restrictive national action could be taken only after persuasive evidence shows serious economic or political harm being done to the nation by the failure of states to harmonize their tax practices with those of the federal government and foreign countries. Such national harm could be incurred, for example, if many foreign corporations failed to invest in the U.S., if foreign governments imposed retaliatory taxation on U.S. corporations operation abroad, or if foreign governments declined to conclude tax or other treaties with the United States when such treaties would clearly serve U.S. interests.

5. In the Commission's judgment, the rigorous serious national harm test is clearly superior to the predominant national interest test because it forces federal policymakers to balance two equally important constitutional concerns: promoting the free flow of foreign and domestic commerce and insuring states wide leeway in charting their own tax policies.

6. Because foreign governments have formally objected to state use of worldwide apportionment procedures, the staff conducted a thorough investigation of the grounds for these objections by examining relevant documentation and interviewing practitioners and students of international tax practices. *This staff investigation produced no evidence that state use of worldwide combination had caused harm to the nation.* As noted earlier in this report, there has been no cut-back in foreign investment in the United States, no retaliatory taxation imposed by foreign governments on U.S. corporations operating abroad, and no refusal by foreign governments to conclude tax treaties with the U.S. government.

7. There are two self connecting forces at work that should prevent state tax practices from causing serious national harm in the foreseeable future. First, business enterprises in our federal system are free to locate in states that provide the most congenial tax climate. Thus, interstate tax competition should prevent most states from pursuing state tax policies that are clearly hostile to their economic development fortunes. Second, our judicial system provides the process for determining whether state tax practices conflict with the constitutional interest in achieving a free flow of interstate and foreign commerce and for insuring that no person is deprived of property without due process of law.

RECOMMENDATION

It is clear that (a) our federal system allows the states the widest latitude in determining their own tax structures, (b) the judicial system provides processes for determining whether state tax practices conflict with constitutional standards, (c) business enterprises in our federal system are free to locate in states that provide the most congenial tax climate and (d) there is no evidence that state tax practices cause harm to the nation. Therefore, the Commission recommends that the United States Congress pass no law that will limit state tax practices with respect to multinational corporations or "foreign source" income.

Senator MATHIAS. Thank you very much, Mr. Cory.
Mr. Clarke.

**STATEMENT OF OWEN L. CLARKE, NATIONAL ASSOCIATION OF
TAX ADMINISTRATORS, WASHINGTON, DC**

Mr. CLARKE. Thank you, Mr. Chairman, members of the committee, Senator Hawkins. I appreciate the opportunity to appear before this committee again representing the National Association of Tax Administrators and now as a member of the President's Worldwide Unitary Taxation Working Group.

As you perhaps know, I have participated as an active member in the committees, both Federal and State, which over the past 25 years have sought a resolution of the complex issues involved in the methodology of seeking the proper and fair way to tax corporations engaged in multistate and multinational activities from a State tax point of view.

Suffice it to say that every prior effort, including the very comprehensive one chaired by the distinguished Congressman Willis, with which I worked during its entire span and which spanned 6 years of intensive study and reports, failed to reach any reasonable basis of agreement as between the three involved parties—the Federal Government, State government, and the business community.

Senator MATHIAS. We did pass a couple of bills through one House or the other, but we never got them through both Houses of the same Congress.

Mr. CLARKE. That is true. I appreciate that, Senator. I was there. Senator MATHIAS. It was very frustrating.

Mr. CLARKE. Yes, it was.

The most recent effort, however, under the Presidential committee, I believe, can and will resolve the problems of worldwide combination if the recommendations, as agreed to by the unanimous vote of the State principals, are followed and accepted both by the Federal Government and the State governments.

These recommendations are set forth in the final report, dated August 31, 1984, in option 2 of annex D. In the main, these recommendations are as follows:

First, the States have agreed to resolve a tax problem which the Federal Government has with our trading partners by retreating from worldwide combined income of a unitary business, which the U.S. Supreme Court has found to be permissible and reasonable, to a water's edge methodology, but only under certain conditions.

Second, in limiting the extent of the income base by excluding corporations organized and doing business outside of the United States, the States have recommended a reasonable and workable definition of the water's edge—that is, those corporations which should be included in the new income base.

For the most part there is agreement between the business community and the States on this definition of water's edge with the exception of the so-called "80/20" corporations and certain other tax haven corporations.

Third, the States have recommended that dividends from whatever source received by corporations included in this definition of the water's edge shall be included in the tax base which the States

have a right, though they not necessarily have to, but they have a right to tax.

Fourth, the Federal Government must respond to the needs for substantial expansion in the areas of auditing sections 482, 861 and related provisions of the Internal Revenue Code by increasing the current appropriation level for the Internal Revenue Service by \$50 million over the base for fiscal year 1984.

Fifth, the Federal Government must require large corporations engaged in multistate and multinational operations to submit as a schedule of their Federal corporation tax return a full disclosure of how the corporation actually apportioned its income to each of the States in which it conducts taxable business activity.

Sixth, the Federal Government should finance and support a designated State agent or agencies to which such full disclosure schedules would be submitted for review and analysis. Such agencies would, under rules and regulations, provide audit information and reports to their members for further action.

Seventh, the States have agreed that once the total income of the water's edge group has been determined, including 80/20 corporations and dividends, including foreign source dividends, each State, through its own sovereign power and responding to its inherent right to determine its own tax and economic policy, shall decide to what extent it seeks to tax the full and rightful share of the combined income of the water's edge group.

It may, as California does, tax its share in full, or, as Texas does, not tax it at all, or, as Massachusetts does, tax its share reasonably and judiciously.

The State option in the Working Group Report provides for all those States, which do not currently use the unitary method, a set of tax principles beyond which no such State ought to go if it should decide to enact a unitary taxation method. There is nothing in the report requiring a State to enact a unitary law.

For those States which currently do use the unitary method—using Worldwide Combined Income of the Unitary Tax Business—the report does recommend a retreat, under certain stated conditions, to a water's edge limitation.

The price which those States will pay will be reduced somewhat by the improved administrative procedures which I have referred to at the Federal level, at the State level and in improved compliance and full disclosure at the business community level.

Finally, it was the unanimous position of the Working Group, both State and business representatives, that restrictive Federal legislation should not be the method by which these recommendations would be implemented.

There is no basis for arbitrarily interfering with State tax policy by artificially reducing or restricting the total income of corporations engaged in a unitary business or with each States share of such total income when a relatively standardized apportionment method is applied by the States to such total income.

By retreating from Worldwide Combined to water's edge the States have fully cooperated with the Federal Government in resolving the foreign trading partners concerns. They have voluntarily surrendered an income base which the U.S. Supreme Court has found reasonable and appropriate.

It is now a requirement that the Federal Government, including the Congress, give full support to the recommendations of the Federal agencies which participated in this current project and the business community which has endorsed voluntary State action in resolving the problems involved in taxing corporations engaged in multijurisdictional activities.

Senator MATHIAS. Thank you, Mr. Clarke.

Mr. DILLON.

STATEMENT OF ROBERT DILLON, EXECUTIVE VICE PRESIDENT, FINANCIAL DIVISION, SONY CORP. OF AMERICA, PARK RIDGE, NJ

Mr. DILLON. Thank you, Senator Mathias. Senator Mathias, Senator Hawkins, members of the committee, I appreciate the opportunity of appearing here today. My name is Robert Dillon. I am executive vice president of Sony Corp. of America. I have met Mr. Cory on the field of battle in the past.

Sony has been operating in the United States as a separate subsidiary since 1960. Next year will be our silver jubilee year. In 1971, Sony established a TV plant in California with mixed blessings. It has helped us penetrate the U.S. market, but we have had considerable problems with taxes in California.

My statement has been submitted. I would like to make some remarks related to it, and I would like to agree with Senator Mathias, as I testified 4 years ago to the House Ways and Means Committee, we believe that Federal action is necessary in this area to remove the confusion and the uncertainty that exists, particularly for foreign investors.

They simply have a very difficult time understanding how we operate in this country. Harking back to the speed with which Florida adopted a unitary tax methodology after the *Container* decision, in the absence of Federal legislation, what is to prevent other States to do the same in future years? It is this uncertainty that really has an inhibiting effect on foreign corporations.

We want to pay fair taxes. We do not want to pay less. And in fact, in some years, under unitary Sony would pay more to the State of California, in other years would pay less. So it is not a question of wanting to pay less taxes, simply fair taxes and ones that we can administer with some degree of reasonableness.

As a subsidiary of a foreign corporation, which keeps its books primarily in yen and where everything is consolidated in yen, where the ratio of the yen to the dollar has varied over the past several years from 175 to 330, I think you can appreciate the magnitude of the problem of trying to translate that into U.S. dollars. It would require the setting up of a whole new accounting operation.

We think there is adequate incentive for the IRS to police IRC 482 in that their reward from policing it adequately—and I can assure you from the audit we are currently undergoing, they do police it adequately—there is four times as much at stake for them as there is for any particular State, because, of course, the U.S. income tax rate is that much higher.

Foreign governments have become particularly concerned about this especially since the *Container* decision, but these protests go

back for years. I think the United Kingdom tax treaty was referred to. The French Government submitted a note with its treaty in 1978, the Canadian Government in 1980, the EEC several notes starting in 1980, and the Keidandren in Japan in 1981.

We would like to applaud the Working Group and its efforts to try to bring some order to this area. We would also like to applaud the Governor of California for making some efforts in this area. However, we feel that these efforts are really not going to be productive so long as States can adopt the unitary tax and this is a point that we would like to emphasize.

But even in California, even with the Alquist bill which was presented, there were some major loopholes for the enforcement of that, that were inserted which would have made its adoption in the form that it was presented probably not of major gain for the corporations operating in that State.

We are concerned about the issue of retaliation. We are concerned about the push by foreign governments to renegotiate tax treaties, and the general feeling that this is a U.S. version of a non-tariff trade barrier, as Senator Hawkins mentioned.

Announcements have been made by Fujitsu, NEC, Kyocera, and Sony that they are building plants in States other than California. We hope that this will ultimately get through to the California legislators and tax people, but we are not really hopeful. I agree with Senator Mathias that pious hopes will simply not deal with this problem.

We would like to urge Federal action in this area to try to bring some orderliness to the U.S. market and U.S. tax situation. Thank you very much.

[Mr. Dillon's prepared statement follows:]

PREPARED STATEMENT OF ROBERT DILLON

I would like to thank the Committee for inviting me here today to speak on behalf of Sony Corporation about a major problem affecting potential foreign investment in the United States, as well as the question of the credibility of the U.S. Government. I refer, of course, to the worldwide combined unitary tax method employed by a minority of states in the United States.

The United States has represented a bastion of stability for international investment for many years. Uniformity in the regulation of foreign commerce was recognized in the Constitution as an essential element in encouraging trade and investment between the U.S. and other nations. The Supreme Court has reaffirmed the need for uniformity in international trade by stating that "the Federal government must speak with one voice when regulating commercial relations with foreign governments" and that "foreign commerce is preeminently a matter of national concern." These statements are, of course, consistent with the position of the United States that the "Federal government is charged with the conduct of the nation's foreign relations."

In keeping with this concept of uniformity, an international consensus has been built through years of effort in favor of the "arms-length" method of taxing multinational corporations. As a result, multinational enterprises such as Sony which invest in other countries have based their decisions on the clear understanding that under internationally accepted taxing principles,

only operations which are conducted in the host countries will be subject to tax. The accepted understanding is that the host country will not, through taxes on operations in the host countries, try to reach out and tax the profits of the parent enterprise or any of its other affiliated members. International trade and taxation must be governed by international agreements and not by peculiar and unilateral taxing concepts of individual nations, and certainly not by political subdivisions of nations.

Thus, the conflict between the worldwide combined reporting states and the rest of the world was inevitable. State, Federal or foreign tax administrators all face the same problem: "How much income is earned in my jurisdiction?" With the exception of the worldwide combined reporting states, all states and all foreign taxing jurisdictions use essentially the same method which the U.S. Federal government uses to answer that question: the separate accounting, arm's length method. In nearly forty income tax treaties which the United States has negotiated, the arm's length method has been adopted, not worldwide combined reporting. This international stance of the United States has also been evidenced in approximately twenty-five treaties of friendship and commerce which the United States has entered into with foreign nations.

Let us for a moment look at the global support for the arm's length method.

The United States is a member of the Organization for Economic Cooperation and Development. Its Model Income Tax Convention and the 1974 guidelines for tax treaties between developed and undeveloped countries adopted arm's length as the standard. Articles 7 and 9 of the 1977 Model Double Taxation Convention on Income and Capital of the OECD, also provide for adoption of arm's length. Arm's length is also the standard in the United Nations' Model Double Taxation Convention between developed and developing countries.

Against this global support for the arm's length method are arrayed the ten states that use worldwide combined reporting: Alaska, (except for oil companies), California, Colorado, Florida, Idaho, Massachusetts, Montana, North Dakota, Indiana and Utah. (Parenthetically, recognizing the adverse long term effect of the unitary method, Oregon has repealed its unitary law. Florida, Indiana and Massachusetts seem likely to follow suit.)

Article 9 (4) of the income tax convention with the United Kingdom and Northern Ireland, as amended (1975), was largely a reaction to the extension of the unitary method to include the operations of a foreign parent of a U.S. subsidiary as well as other affiliates throughout the world.

The United Kingdom eventually accepted the treaty after Section 9 (4) was removed on the understanding that Congress would take steps to resolve the problem in a satisfactory manner. More than 8 years have passed without any apparent progress! Foreign countries and business have looked to the U.S. to speak with one voice in international tax matters. Foreign and U.S. pressure have continued to build over the past 8 years.

1. France informed the U.S. government of its opposition to worldwide combined reporting in a note attached to its treaty with the U.S. on November 24, 1978. On September 26, 1980, Canada attached a note to its treaty with the United States objecting to the use by a few states of worldwide combined reporting. The European Economic Community has filed five diplomatic notes with the U.S. Department of State opposing the use of worldwide combined reporting since March 19, 1980. The Keidandren (Federation of Economic Organizations, Japan) issued its "resolution for urging an abolition of the unitary tax formula based on worldwide income by state authorities of the United States of America on December 8, 1981."

2. The Solicitor General of the United States filed an Amicus Curiae brief in the Chicago Bridge & Iron Company case and argued that the Federal government considered the imposition of

a state income tax on the apportioned combined worldwide income of a unitary group of related corporations unconstitutional because it: "impairs Federal uniformity in an area where such uniformity is essential" and it "creates a substantial risk of international multiple taxation".

3. The U.S. Supreme Court in the Container Case upheld the application of worldwide combined reporting to a domestic parent corporation and its overseas subsidiaries which were found to be "unitary". However, a footnote pointed out that the decision did not address the situation involving a U.S. subsidiary of a foreign parent.

4. The British Ambassador and the Chancellor of the Exchequer met with Treasury Secretary Regan in July 1983 to discuss the potential harm to U.S. and British relations if the U.S. government did not take some positive action.

5. On August 11, 1983, the Embassy of Japan delivered to the Department of State an aide-memoire which advised that worldwide combined reporting has:

"...A discouraging effect on Japanese investment in the U.S. and hampers the sincere efforts by the U.S. and Japanese governments to actively promote Japan-U.S. investment."

The aide-memoire concluded as follows:

"The government of Japan further requests that the U.S. government take concrete measures as soon as possible, including possible legislative actions, which will lead to the abolition of the unitary tax system."

On the same date, Marc Lalone, Minister of Finance for Canada, wrote to Secretary Regan urging that the problems posed by the use of worldwide combined reporting be resolved.

6. One year ago, the Cabinet Council on Economic Affairs . . . unanimously recommended that the administration support the "water's edge" limitation on worldwide combined reporting. Instead, the President decided on September 23, 1983, to form the Working Group on worldwide unitary taxation to "develop a federal policy that is conducive to harmonious international economic relations while respecting the fiscal rights and privileges of the individual states."

7. The Keidandren sent over a delegation in February 1984 and then again in June 1984 to visit approximately 23 states including all of those which employ the worldwide unitary taxation method. In addition, the group met with the President and the Secretary of the Treasury. Their mission was a positive one -- to find

prime locations for investment in the United States. They made it clear, however, that, to the extent that the United States as the host country fails in its obligation to insure fair and rational taxation, Japanese companies as well as other foreign parent multinationals will be reluctant to invest further funds here.

Each of the countries I have just mentioned is looking for uniform and equitable tax treatment between their own countries and their trading partners. Since the Working Group has failed to reach a consensus, it is difficult to predict with accuracy what actions these foreign governments will take. We might expect to see requests for renegotiation of tax treaties. Some companies may even urge that their home countries adopt retaliatory measures. Such action may be viewed as an overreaction. However, no one should be surprised if the patience of foreign governments and businessmen has worn thin:

- After a Congressional Committee recommended that worldwide combined reporting be limited;
- After eight years of treaty negotiations;
- After being assured that a solution would be found;
- After a Solicitor General's brief said that worldwide combined reporting was unconstitutional;
- After the Cabinet Council on Economic Affairs unanimously recommended that worldwide combined reporting should be

limited by the Federal government;

- After filing diplomatic note upon diplomatic note;
- After having to resort to the unheard of diplomatic step of filing Amici briefs in the Supreme Court of the United States.

(Even the wheels of the gods grind faster than that!)

Businessmen of all nationalities cannot understand why the U.S. government has not taken action. Nor can foreign governments understand how the Federal government can permit 10 states to override clear Federal prerogatives. Aside from the general problems of the unitary tax method, there is a clear perception among foreign government officials and business leaders that the unitary tax, as applied by local governments, is unfair, irrational and virtually inexplicable. That perception clearly inhibits foreign investments.

Furthermore, so long as the worldwide unitary method can be used by one state, any state can adopt it. That possibility could well dissuade some foreign companies considering a major, long-term investment from making it in any of these United States!

We at Sony believe that all multinational enterprises must work together for the healthy growth of the world economy. To achieve

such a generally accepted goal, world trade and investments need to be actively promoted.

Sony is proud of its role in these efforts particularly through a number of manufacturing investments in the U.S., involving Sony's proprietary technology. In addition, Sony provides employment to more than 6,000 Americans.

The chilling impact of the worldwide unitary tax system cannot be disregarded. It is imperative that the Federal government reestablish its credibility with our trading partners by taking immediate action. The U.S. government must speak with one voice in order to encourage investment and provide the stability necessary to promote it.

Thank you

Senator MATHIAS. Thank you very much.
Mr. CAUDILL.

STATEMENT OF JAMES K. CAUDILL, ESQ., TAX COUNSEL, BATUS,
INC., LOUISVILLE, KY

Mr. CAUDILL. Thank you for this opportunity to appear today on behalf of BATUS Inc. My name is James Caudill. I am the tax counsel for BATUS.

Let me first explain what BATUS is and why the unitary tax issue is so important to us. BATUS is a wholly owned subsidiary of BAT Industries, p.l.c.—the British-American Tobacco Group—headquartered in London, England. BATUS, headquartered in Louisville, KY, is the chief holding company for most of BAT's U.S. operations.

It employs about 63,000 people; its operating subsidiaries are fairly well known. They include Brown & Williamson Tobacco Corp., retail enterprises—Marshall Field in Chicago, Gimbel Brothers in New York, Saks Fifth Avenue in New York, a large paper company in Wisconsin, Appleton Papers, Inc., and some smaller companies as well. J. B. Ivey operates in the Carolinas and in Florida. And we have numerous other establishments.

We pay taxes in and do business in virtually every State in the Union. Our parent, BAT, has been a persistent opponent of worldwide unitary combination for many years. BAT's position is simply that worldwide unitary combination is economically unrealistic and legally unsound because the community of nations has, for many years, by general asset agreed to use the tax system based upon the principle that a multinational enterprise should be taxed in each country on the income it actually earns there, and that affiliated companies must do business with each other based on arm's length intercompany charges for goods and services.

The establishment of the arm's length intercompany pricing rules as the internationally accepted standard of taxation is perhaps the most lasting accomplishment of the League of Nations. Use of an inconsistent and incompatible method by a few States threatens to undermine the entire structure of international tax agreements so laboriously constructed over a period of more than 60 years. Thus, worldwide unitary combination is a threat to the entire world economic system.

Because property values and labor costs are higher in the United States than in most of the rest of the world, simply apportioning worldwide income on worldwide factors generally attributes much more income to the taxing U.S. States than accounting based on arm's length standards. In a nutshell, worldwide combination is bad accounting because it results very often in a geographical mismatch of U.S. income against wages and other costs of doing business incurred in Third World countries.

The result is State taxation of income earned outside the United States and certainly outside the borders of the taxing State—to which BAT objects on moral as well as on legal grounds. BAT, however—and this must be emphasized—is in the minority of companies which fairly consistently pays lower taxes under worldwide combination than under the arm's length system, simply because

its overseas tobacco operations, which are the bulk of its income, are consistently relatively less profitable than tobacco operations in the United States. We think our case is not unique, but it is in the minority.

The Task Force on Unitary Taxation, of which I was a member, held extensive hearings on almost every aspect of the unitary tax question. No less than seven foreign governments, all of whom are major trade partners of the United States, submitted oral or written testimony in opposition to worldwide apportionment. In addition, many foreign and domestic corporations submitted testimony which proved that the then 12, now, fortunately, only 11 unitary tax States are taxing income earned abroad.

The most egregious example perhaps was submitted by Gulf Oil Co., which demonstrated very convincingly that California had imposed a tax on at least 1,200 percent more income than Gulf could have earned in the State of California. Testimony in favor of worldwide apportionment consisted mainly of unsubstantiated but frequently repeated charges that corporations manipulate intercompany prices to evade taxes.

The Internal Revenue Service, to the contrary, testified that it polices intercompany pricing very rigorously, has special audit forces for more than a dozen of the major industries operating abroad, and that it collects most of the revenue legally due.

The task force simply failed to agree on a method of taxation because the States doggedly insisted on their right to tax foreign-source dividends. The 80/20 issue was also an important one.

The States have frequently asserted that federalism should bar Federal action. True federalism, to the contrary, simply requires action.

Thank you again for this opportunity to appear on behalf of BATUS.

[Mr. Caudill's prepared statement follows:]

September 20, 1984

Testimony of James K. Caudill, Tax Counsel,
BATUS Inc., Before the Senate Committee on
Foreign Relations Subcommittee on
International Economic Policy

Thank you for this opportunity to appear today on behalf of BATUS Inc. Let me first explain what BATUS is and why the worldwide unitary taxation issue is important to us. BATUS is a subsidiary of B.A.T Industries, p.l.c. - the British-American Tobacco Group - headquartered in London, England. BATUS, based in Louisville, Kentucky, is the holding company for most of B.A.T's operations in this country, including Brown & Williamson Tobacco Corporation, department stores such as Gimbel Brothers and Saks Fifth Avenue in New York, Marshall Field in Chicago, Frederick & Nelson in Seattle and J. B. Ivey in the Carolinas and Florida, and a paper company in Wisconsin, Appleton Papers, Inc. BATUS has over 63,000 employees in the United States. BATUS does business in, and pays taxes to, every state in the Union.

B.A.T has been a persistent opponent of the worldwide unitary method of tax apportionment for many years. B.A.T's position is that worldwide apportionment is economically unrealistic and legally unsound because the community of nations has by general assent agreed to use a tax system based upon the

principle that a multinational should be taxed in each country on the income it actually earns there, and affiliated companies must charge each other arm's length prices for goods and services. The establishment of arm's length intercompany pricing rules as the international standard of taxation is perhaps the most lasting accomplishment of the League of Nations. Use of an incompatible method by a few states threatens to undermine the entire structure of international tax agreements so laboriously constructed over more than 60 years. Thus, worldwide unitary combination is a threat to the world economic system.

Because property values and labor costs are higher in the United States than in most of the rest of the world, simply apportioning worldwide income on worldwide factors generally attributes much more income to the states than tax accounting based on arm's length pricing principles. In a nutshell, worldwide combination is bad accounting because it often requires a geographical mismatch of U.S. income against Third World wages and other expenses. The result is state taxation of income earned outside the state - and even outside the United States - to which B.A.T. objects on moral as well as legal grounds. B.A.T., however, is one of the minority of companies which actually enjoys tax savings with worldwide combination simply because its U.S. operations are relatively more profitable than its operations elsewhere.

The Task Force on Unitary Taxation, of which I was a member, held extensive hearings on every aspect of the unitary tax issue. No less than seven foreign governments presented oral or written testimony in opposition to worldwide apportionment. In addition, many foreign and domestic corporations submitted testimony which proved that the then 12 - now 11 - unitary tax states are taxing income earned abroad. Gulf Oil Company, for example, convincingly demonstrated that California imposed a tax on 1200% more income than Gulf could have earned in the state. Testimony in favor of worldwide apportionment consisted mainly of unsubstantiated charges that corporations manipulate intercompany prices to evade taxes. The Internal Revenue Service testified that it polices intercompany pricing rigorously, with special audit task forces for more than a dozen industries, and that it collects most of the revenue legally due.

The Task Force and Working Group failed to agree on a method of taxation acceptable both to business and the states because the state representatives doggedly asserted their right to tax foreign source income. As an alternative to worldwide apportionment the states proposed to apportion domestic net income plus dividends from foreign subsidiaries based solely on domestic payroll, property and sales factors. Since no state grants any credit or even a deduction for foreign taxes, the result is economic double taxation combined with over-apportionment of

income. There is no theoretical justification for such an approach to state taxation of multinational corporations. The result is even worse than worldwide combination because it ignores the property, payroll and sales of foreign subsidiaries in the apportionment while taxing distributions of income earned by those subsidiaries and fully taxed by foreign governments. Legislation such as the recent Alquist-Hughes proposal in California is not in compliance with the principles of the Working Group Report.

The Oregon legislature recently repealed worldwide combination outright. California and Florida, on the other hand, demonstrated that they do not intend to take steps to redress any of the international grievances arising from extraterritorial taxation. Federal action is therefore needed more urgently now than ever.

Testimony before the Task Force showed that worldwide apportionment is contrary to Federal tax and trade policy. It is an impediment to international commerce. Foreign governments are increasingly angry and dismayed that the United States still does speak with one voice on this international issue even after years of controversy. The British government in particular was assured that unitary taxation would be dealt with domestically when it agreed in 1978 to ratify the new tax treaty with the United

States without Article IX(4), which would have outlawed worldwide combination for British companies. The United States has failed to make good on that promise, though the promise has now been repeated by two administrations. The United States is thus permitting a few states not only to flout its own tax and trade policies but also to ignore the justifiable complaints of Great Britain, America's staunchest ally. It is time for the Congress to end this charade by appropriate legislation. Not even Stonewall Jackson, in the heyday of the states rights doctrine, ever asserted that states' rights extend beyond the "water's edge", yet a few states now insist on reaching worldwide for tax revenue. States rights and federalism are catch phrases used by the states to resist Federal intervention. True federalism demands that the Federal government take action now.

One further point. The Working Group and Task Force on Unitary Taxation have stirred high expectations for relief in foreign countries. Failure by the Federal government to follow through would now be perceived by our trading partners as a deliberate slap in the face. That cannot be in the best interest of America.

Again, thank you for this opportunity to testify.

Senator MATHIAS. Thank you, Mr. Caudill.

Senator Nething, do you want to be the cleanup hitter here?

**STATEMENT OF HON. DAVID NETHING, MAJORITY LEADER,
STATE SENATE OF NORTH DAKOTA**

Senator NETHING. Thank you very much, Mr. Chairman, Senator Hawkins. It is rather appropriate that I sit between these two groups, with the administrators here and the private sector here, and I want to bring to this committee the perspective of the policy-making branch of State government, the State legislatures.

Senator MATHIAS. We hope that we in the legislative world are the policymakers.

Senator NETHING. Sometimes there is some question.

Senator MATHIAS. There are moments of gnawing doubt. [Laughter.]

Senator NETHING. Right. Mr. Chairman, I sit here today as the senate majority leader of our State, as the vice president of the National Conference of State Legislators. I am a member of the Advisory Commission on Intergovernmental Relations and I was a member of the Working Group that Secretary Regan appointed.

The final report that was submitted by the Working Group contains three principles which cover the major problem, at least from the State legislators' perspective, that we were addressing: First of all, that a water's edge limit to unitary taxation under certain circumstances can be acceptable to both States and domestic multinational businesses.

Second, that States need increased assistance and cooperation from the Federal Government to make this water's edge limitation more effective, and the Federal Government, through the Treasury Department, has promised this support.

And, third, that a competitive balance or fair and equitable tax treatment should be established for foreign-based multinationals, domestic multinationals, and domestic businesses.

The report says, "a cooperative, voluntary approach based on consensus offered the best choice of obtaining a solution." So we agreed in principle that the water's edge limitation can be acceptable even though we proposed six different possible water's edge packages. We agree on what would constitute useful assistance and cooperation, and finally we agreed on a principle of competitive balance. Again, I quote from the report: "The Working Group makes no recommendations to the States as to how to achieve a competitive balance and expects that decision to be made by each State."

Now there were some things that the Working Group could not do. While it could set guidelines for the formulation of State tax policy, it could not actually set policies because important actors and players were missing. State legislatures offer a comprehensive forum, with all affected taxpayers having an opportunity to be present—the foreign multinationals, domestic multinationals, large domestic multistate business, small business, individual taxpayers, property owners, and all of these people who need the services that taxes are designed to pay for.

The Working Group, on the other hand, was a few elected State officials, a few State tax administrators, a few domestic multinational CEO's or officers, with no such broad base of affected taxpayers like they will have in the hearings as they come before the State legislatures.

I think the Working Group established and accomplished a great deal. And the proof is that there is now a much more informed debate than just 1 year ago on the subject of the unitary question. For example, State legislators are discussing various definitions of 80/20 corporations and are looking at the tax treatment of domestic dividends as well as dividends from foreign subsidiaries. Legislators are also comparing their State tax structures with their neighboring States.

Mr. Chairman, I do have and would like to submit for the record a summary of what has taken place within five States up to this date just since this question has been brought to the attention of the Working Group and what has taken place.

Finally, I would like to recall an earlier study carried out by the Advisory Commission on Intergovernmental Relations, of which, as I indicated, I am a member. The report was issued a little more than a year ago and established the principle of serious demonstrated national harm as a test for the need of Federal action on the issue of State tax treatment of multinationals.

There have been threats of retaliation for years, but foreign corporations still want to invest in the United States. If they would just limit their investments to those who did not have worldwide unitary, they would still have 39 States within which they can do that. They may argue that Florida's rapid adoption of worldwide unitary is proof that in a year's time any State could adopt this tax.

On the other hand, I think Florida is an example of the opposite point, that foreign multinationals do have a strong voice in influencing State tax policy. Until demonstrated national harm can be shown, I do not feel there is any reason to preempt State tax practices.

The Working Group final report clearly explains the agreement, that States need help from the Federal Government to effectively use separate accounting beyond the water's edge. We ask your support for that assistance as a sign of this committee's willingness to find a solution to the problem.

Thank you, Mr. Chairman. I would be happy to respond to any questions you may have.

[Senator Nething's prepared statement and attachment follow:]



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STATEMENT

OF

DAVID NETHING, NORTH DAKOTA

SENATE MAJORITY LEADER

VICE PRESIDENT

NATIONAL CONFERENCE OF STATE LEGISLATURES

MEMBER:

PRESIDENT'S WORKING GROUP ON WORLDWIDE UNITARY TAXATION

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY

U.S. SENATE

CHAired BY: SENATOR CHARLES McC. MATTHIAS, MARYLAND

ON

THE FINAL REPORT OF THE WORKING GROUP ON WORLDWIDE UNITARY TAXATION

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE. THANK YOU FOR THIS OPPORTUNITY TO TESTIFY ON WHAT IS OBVIOUSLY A TOPIC OF CONCERN TO MANY PEOPLE. MY NAME IS DAVID NETHING AND I SERVE AS MAJORITY LEADER IN THE NORTH DAKOTA SENATE REPRESENTING JAMESTOWN. I ALSO SERVE AS VICE PRESIDENT OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES AND I WAS HONORED TO SERVE AS A MEMBER OF THE PRESIDENT'S WORKING GROUP ON WORLDWIDE UNITARY TAXATION.

I AM HERE TODAY WEARING ALL OF THOSE HATS AND WOULD LIKE TO TOUCH ON THE FOLLOWING POINTS:

- WHAT THE WORKING GROUP'S FINAL REPORT SAYS;
- WHAT THE WORKING GROUP COULD NOT DO;
- WHAT STATE LEGISLATURES ARE DOING; AND
- SEVERAL CONCERNS ABOUT FEDERAL PROHIBITIONS ON WORLDWIDE UNITARY.

I'M PLEASED THAT THE FINAL REPORT OF THE WORKING GROUP HAS CAUGHT YOUR ATTENTION. I THINK IT WAS A COURAGEOUS EFFORT AND GENUINE ACCOMPLISHMENT. THOSE OF YOU WHO HAVE TAKEN THE TIME TO READ WHAT IS A LONG AND TECHNICAL DOCUMENT WILL REALIZE HOW MANY PROBLEM AREAS HAVE BEEN REDUCED TO ALTERNATIVE SOLUTIONS AND HOW MANY COMPLEX CONTROVERSIAL TOPICS HAVE BEEN RESOLVED AT LEAST INTO COMMON TERMS. FOR INSTANCE WE HAVE A CONCRETE WORKING MODEL OF A DOMESTIC SPREADSHEET FOR THE REPORTING OF INCOME ON A STATE-BY-STATE BASIS. WE HAVE AN EFFECTIVE DESCRIPTION OF THE ACTUAL SUPPORT AND ASSISTANCE WHICH STATES NEED FROM THE INTERNAL REVENUE SERVICE TO GUARANTEE THAT USEFUL AUDITING CAN BE DONE BY STATES THAT DEVELOP OR USE A WATER'S EDGE UNITARY POLICY, AND WE HAVE A FULL LIST OF THE TYPES OF CORPORATIONS WITH OVERSEAS ACTIVITIES WHICH STATES SHOULD REVIEW FOR THE PURPOSES OF FAIR AND EFFECTIVE TAX POLICY.

THE FINAL REPORT ALSO CONTAINS THREE PRINCIPLES WHICH COVER THE MAJOR PROBLEM WE WERE ADDRESSING: 1) THAT A WATER'S EDGE LIMIT TO UNITARY TAXATION UNDER CERTAIN CONDITIONS CAN BE ACCEPTABLE TO BOTH STATES AND DOMESTIC MULTINATIONAL BUSINESSES; 2) THAT STATES NEED INCREASED ASSISTANCE AND COOPERATION FROM THE FEDERAL GOVERNMENT TO MAKE THIS WATER'S EDGE LIMITATION MORE EFFECTIVE, AND THE FEDERAL GOVERNMENT HAS PROMISED THIS SUPPORT; AND 3) THAT A COMPETITIVE BALANCE -- OR FAIR AND EQUITABLE TAX TREATMENT -- SHOULD BE ESTABLISHED FOR FOREIGN BASED MULTINATIONALS, DOMESTIC MULTINATIONALS AND DOMESTIC BUSINESSES.

FINALLY, THE REPORT SAYS AND I QUOTE HERE, "THAT A COOPERATIVE VOLUNTARY APPROACH BASED ON CONSENSUS OFFERED THE BEST CHOICE OF OBTAINING A SOLUTION..." END OF QUOTE. THUS WE AGREED IN PRINCIPLE THAT WATER'S EDGE LIMITATION CAN BE ACCEPTABLE, ALTHOUGH WE HAVE PROPOSED 6 DIFFERENT POSSIBLE WATER'S EDGE PACKAGES. WE AGREED ON WHAT WOULD CONSTITUTE USEFUL ASSISTANCE AND COOPERATION. FINALLY WE AGREED ON A PRINCIPLE OF COMPETITIVE BALANCE, BUT -- AGAIN I QUOTE -- "THE WORKING GROUP MAKES NO RECOMMENDATIONS TO THE STATES AS TO HOW TO ACHIEVE COMPETITIVE BALANCE AND EXPECTS THAT DECISION TO BE MADE BY EACH STATE."

THAT BRINGS ME TO MY SECOND POINT, WHAT THE WORKING GROUP COULD NOT DO. WHILE IT COULD SET GUIDELINES FOR THE FORMATION OF STATE TAX POLICY, IT COULD NOT ACTUALLY SET POLICIES BECAUSE IMPORTANT ACTORS AND PLAYERS WERE MISSING. STATE LEGISLATURES OFFER SUCH A COMPREHENSIVE FORUM WITH ALL AFFECTED TAXPAYERS: FOREIGN MULTINATIONALS, DOMESTIC MULTINATIONALS, LARGE DOMESTIC MULTISTATE BUSINESSES, SMALL BUSINESSES, INDIVIDUAL TAXPAYERS, PROPERTY OWNERS -- THOSE RESIDENTS WHO PROVIDE THE MARKET AND THE CLIMATE OF PRODUCTIVE AND HONEST LABOR AND WHO NEED THE SERVICES THAT TAXES ARE DESIGNED TO PAY FOR. THE WORKING GROUP WAS A FEW STATE ELECTED OFFICIALS, A FEW STATE TAX ADMINISTRATORS, A FEW DOMESTIC

MULTINATIONAL CEO'S OR OFFICERS, ETC., NO SUCH BROAD BASE OF AFFECTED TAXPAYERS OR CITIZENS. I BELIEVE WE ACCOMPLISHED A GREAT DEAL AND THE PROOF IS THAT THERE IS NOW A MUCH MORE INFORMED DEBATE THAN JUST ONE YEAR AGO ON THE UNITARY QUESTION. FOR EXAMPLE, STATE LEGISLATORS ARE DISCUSSING VARIOUS DEFINITIONS OF 80/20 CORPORATIONS AND ARE LOOKING AT THE TAX TREATMENT OF DOMESTIC DIVIDENDS AS WELL AS DIVIDENDS RECEIVED FROM FOREIGN SUBSIDIARIES. LEGISLATORS ARE ALSO COMPARING THEIR STATE'S TAX STRUCTURE WITH THEIR NEIGHBORING STATES'. PERHAPS ONE VERY HEALTH BY-PRODUCT OF THIS EFFORT MIGHT BE GREATER UNIFORMITY IN STATE CORPORATE TAXATION.

BUT THE POINT I WISH TO MAKE IS BACKED UP BY THE ACTIVITIES IN MANY STATE LEGISLATURES. I HAVE PROVIDED YOU WITH COPIES OF AN NCSL PUBLICATION CAPITOL TO CAPITOL WHICH OUTLINES WHAT HAS HAPPENED TO DATE IN 5 OF THE 12 STATES WHO WERE USING WORLDWIDE UNITARY TAXATION: CALIFORNIA, MASSACHUSETTS, OREGON, INDIANA AND FLORIDA. THE ISSUE HAS BECOME A MAJOR FOCUS OF LEGISLATIVE DEBATE ALREADY IN FOUR OF THESE FIVE STATES, AND OREGON HAS REVISED THEIR LAW TO A WATER'S EDGE. IN LESS THAN ONE MONTH FROM THE SUBMISSION OF THE FINAL REPORT, I THINK THAT IS A SHOWING OF CONSIDERABLE CONCERN.

FINALLY, I'D LIKE TO RECALL AN EARLIER STUDY CARRIED OUT BY THE ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS (ACIR), OF WHICH I AM ALSO A MEMBER. THAT REPORT ISSUED ONLY A LITTLE MORE THAN A YEAR AGO ESTABLISHED THE PRINCIPLE OF SERIOUS DEMONSTRATED NATIONAL HARM AS A TEST FOR THE NEED OF FEDERAL ACTION ON THE ISSUE OF STATE TAX TREATMENT OF MULTINATIONALS. THERE HAVE BEEN THREATS OF RETALIATION FOR YEARS BUT FOREIGN CORPORATIONS STILL WANT TO INVEST IN THE U.S. IF THEY LIMIT THEIR INVESTMENTS TO 39 STATES TODAY, THEY WON'T BE SUBJECT TO WORLDWIDE UNITARY TAXATION. THEY MAY ARGUE THAT FLORIDA'S RAPID ADOPTION OF

WORLDWIDE UNITARY LAST YEAR IS PROOF THAT IN A YEAR'S TIME ANY STATE MAY ADOPT THIS TAX. HOWEVER, FLORIDA MAY BE AN EXAMPLE OF THE OPPOSITE POINT: THAT FOREIGN MULTINATIONALS DO HAVE A STRONG VOICE IN INFLUENCING STATE TAX POLICY.

UNTIL DEMONSTRATED SERIOUS NATIONAL HARM CAN BE SHOWN, I DON'T FEEL THERE IS ANY REASON TO PREEMPT STATE TAX PRACTICES. THE WORKING GROUP FINAL REPORT CLEARLY EXPLAINS THE AGREEMENT THAT STATES NEED HELP FROM THE FEDERAL GOVERNMENT TO EFFECTIVELY USE SEPARATE ACCOUNTING BEYOND THE WATER'S EDGE. I ASK YOUR SUPPORT FOR THAT ASSISTANCE AS A SIGN OF YOUR WILLINGNESS TO FIND A SOLUTION.

THE FINAL REPORT ALSO MAKES CLEAR THAT STATES NEED TO USE THE APPORTIONMENT METHOD TO REASONABLY AND EFFECTIVELY TAX INTERSTATE BUSINESSES. USING THIS PRACTICE WORLDWIDE IS ONLY AN ATTEMPT TO IMPROVE THE EQUITY AND FAIRNESS OF OUR TAX SYSTEMS. I URGE YOU TO DEVOTE YOUR TIME AND RESOURCES TO FURTHER IMPROVING THE TAX LAWS AND TAX TREATIES SO THAT SEPARATE ACCOUNTING CAN BE MORE EFFECTIVELY AND EFFICIENTLY USED BY BOTH STATES AND THE FEDERAL GOVERNMENT.

THANK YOU.

I'D BE GLAD TO TRY TO ANSWER ANY QUESTIONS YOU MIGHT HAVE.

[From Capital to Capital, National Conference of State Legislatures, Sept. 17, 1984]

WORKING GROUP REPORT FINALIZED: STATES REVISING UNITARY TAX STRUCTURES

On September 4, President Reagan received the final report of the Worldwide Unitary Taxation Working Group, covering a 12-month effort by state and business representatives to reach a compromise on this complex issue. During this same year, a number of state legislatures have taken steps to change their worldwide unitary tax laws.

"Together these efforts represent an approach to a key state-federal concern that maintains each state's autonomy, but demonstrates the effectiveness of a federal role in fostering discussion and negotiation," said Sen. David Nething (ND), NCSL vice president and member of the Working Group.

While members of the Working Group did not reach a mutual solution, they did attempt to draft a few principles that could guide a state in changing from the worldwide unitary method of taxation. These principles are: (1) water's edge unitary combination for both U.S.- and foreign-based companies under certain conditions; (2) increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability; and (3) competitive balance for U.S. and foreign multinationals and purely domestic businesses.

In comments submitted in the final report of the Working Group, business members pointed out that principle two depended on the states effectively following principles one and three. State members submitted a statement explaining that only if principles two and three were followed would principle one be acceptable.

The Chairman's report makes it clear that two central issues are to be decided by the states: (1) treatment of domestic subsidiaries with most of their business activity or earnings outside the U.S. (so-called "80/20" corporations); and (2) treatment of dividends from foreign subsidiaries.

Several states, meanwhile, have begun their own examinations of the unitary tax situation and are making changes.

In a one-day special session on July 30, the Oregon Legislature repealed the state's worldwide unitary law and enacted a water's edge provision that includes 80/20 corporations but allows an exclusion of 85% of dividends received from foreign affiliates. The governor signed the legislation, which was promoted as a jobs bill and a state economic development proposal and the law will become effective July 1, 1985. During their 1985 session, Oregon legislators will address how to replace the \$15 million in annual revenues expected to be lost through this repeal.

In California, the Senate adopted a proposal, drafted at the suggestion of the governor, which would offer multinational corporations a one-time choice of worldwide unitary or water's edge unitary including 80/20 corporations, with all dividends available for apportionment purposes. The California Assembly Ways and Means Committee had adopted a measure containing the Senate provision and a simple elimination of worldwide unitary taxation for U.S. subsidiaries of foreign multinational corporations. The full Assembly did not act on the measure, but it is likely to be debated by the new legislature.

Before adjournment in early June, both houses of the Florida Legislature passed bills repealing worldwide unitary taxation, but the bills differed on the means of replacing the \$73.6 million in lost revenues for FY 1985. Representative James Harold Thompson, who will become Speaker of the House following the November elections, said "There is conceptual agreement among many members that worldwide unitary should be repealed. The work now is to find a suitable replacement for the revenue we'll lose." One often-discussed alternative is an increase of one-half percent in the Florida corporate income tax rate.

In Indiana, the Commission on State Tax and Financing Policy is responding to a commitment, given to the governor by a bipartisan group of legislative leaders, to rewrite the law. The task before the commission is to draft a law that will protect foreign corporations from having to file on a worldwide basis, protect the right of corporations that wish to file on a worldwide unitary basis, maintain the capability to enforce effective audits, and yet not give foreign corporations an advantage over domestic corporations.

Finally, in Massachusetts, where a worldwide unitary taxation provision currently is not enforced on foreign parent corporations, the governor's office has proposed legislation that would establish a water's edge limitation on the tax, while at the same time establishing a new corporate tax to fund Massbank, a recently proposed infrastructure bank. The bill has been reported by the Joint Taxation Committee but not yet debated by either house.

NCSL contact: Tim Masanz, Washington.

Senator MATHIAS. Thank you very much, Mr. Nething.

I will restrict my line of questions because we do have other witnesses to hear today. But as I recall the statement that Mr. Cory read, attributed to President Reagan, I was interested in the exact words that President Reagan used.

President Reagan is often accused of having extraordinarily good luck, but we usually make our own luck as we go along in life. I noted that he was cautious enough to add to that statement at the end something like "except in the last resort."

Mr. CORY. The exact quote, if you would like it, is "Federal intervention in the State taxation field is both undesirable and dangerous and should only be considered as a last resort. Sincerely, Ronald Reagan, Governor."

Senator MATHIAS. Right. There is an escape clause there.

Mr. CORY. That is not unusual of his statements. [Laughter.]

Senator MATHIAS. It might be worthwhile since we have such a distinguished panel here just to review how all of this came about. I take a sort of personal interest in it because it all began in the State of Maryland. The King of England, Charles I, gave a charter to Lord Baltimore of all the territory which presently comprises the State of Maryland. That charter ran to the mean low-water mark on the south bank of the Potomac River, so that the whole of the Potomac River was in the State of Maryland.

At some point shortly after the Revolutionary War Maryland prohibited Virginians from fishing in the Potomac. The Virginians took some umbrage at this restriction, particularly those whose farms adjoined the Potomac. They retaliated by prohibiting Maryland ships from passing through the Virginia Capes to and from the Chesapeake Bay, so that Maryland commerce was bottled up in the Chesapeake Bay.

There was an impasse. Obviously this was an impractical and ridiculous situation. Being the practical person that he was, George Washington invited representatives from Maryland and Virginia to come to Mt. Vernon and discuss the problem. The result of that meeting was the Potomac River Compact of 1785 by which Maryland granted to Virginians the right to fish in the Potomac in return for the right to pass through the Virginia Capes between the Atlantic Ocean and the Chesapeake Bay.

It turned out to be a singularly bad bargain for Maryland because under the navigable waters provision of the Constitution several years later we got the right to travel through the Capes anyway and the Virginians have been fishing in perpetuity in our river ever since. [Laughter.]

There was a failure of consideration, but the compact is still in force. It was that episode which induced the commissioners from Maryland and Virginia to suggest that there ought to be a meeting between all of the then-existing States to discuss questions of burdening of interstate commerce, a burdening of interstate commerce that was detrimental to the welfare of the entire country.

That meeting was held in Annapolis the following year and they concluded that the problem did exist and was so serious that they needed further authority to deal with it and suggested a second conference which was convened in Philadelphia for the purposes of considering burdens on interstate commerce in 1787.

That, of course, became the great Constitutional Convention which wrote the present Constitution of the United States. So the Constitution really had its origins in the very kind of disputes that are before us today.

Now the reason I referred to President Reagan's statement is that he does talk about a last resort. We are facing a situation in which I think there is a serious problem affecting the entire national commerce. Now you were present in the room and heard Mr. Pearlman and Mr. Bale testify with respect to the administration's position, and reflected in that position is a concern over the commercial position of the United States of America.

I think it was Mr. Mica who mentioned the fact that in the last quarter we have a trade deficit of approximately \$25 billion that may go as high as \$120 billion for the year. Even more disastrous, as I look at it, is the net accounts deficit which is going to be something like \$80 billion this year against a previous high of \$15 billion.

So as Arthur Burns has said, we are going to have a net accounts deficit which is awesomely different, in Arthur Burns words, from anything we have ever experienced before. Now we are facing very serious problems in this field and we may come to a last resort.

And the States have had almost a quarter of a century to come to some voluntary agreement on this, but it has not happened yet. Now I do not mean for this to turn into a lecture for you, but I am really at a loss to describe this as much less than a last resort, Mr. Cory.

Mr. CORY. Are you inviting a response?

Senator MATHIAS. I am inviting your response.

Mr. CORY. California has used the unitary accounting principle and combination for a great length of time, and during that period of time the record is relatively clear that California has attracted a vast amount of foreign investment.

It is also, I think, very important to realize that the failure of the Governor's plan must be laid at the hands of the domestic multinational corporations who have historically exported jobs from this Nation to foreign countries and are trying to protect that advantage as they deal with the foreign dividend question. That is why they killed the water's edge proposal in California. That is their economic interest.

What I am suggesting with these comments is that when you look at the number of Japanese investments in the United States, California, which has been the leading proponent of unitary, has a disproportionate share of those investments. Currently, something I believe in excess of 26 percent of the U.S. investments of Japanese companies are in California.

California has fared relatively well in attracting capital from throughout the world and throughout the Nation. What I am suggesting in response to that is yes, there are problems, but I would suggest the problems occur as we shift from a domestic economy to a worldwide economy. They are not related to the method and level of taxation in California.

There are existing mechanisms to deal with those pressures, including, as I suggested, the 25137 hearings. If there is a disproportionate level of taxation, the UDIPTA statute does permit the

States to make adjustments. We have made those adjustments for three different corporations, I can think of, that felt that they were being unfairly taxed. They availed themselves and got relief under 25137.

I think we can respond to these problems realistically, on a case-by-case State basis, and the working group's solution, as embodied by Governor Deukmejian's legislation—I think he will try it again next year and—is likely to pass if somehow we can get control over the greed of the domestic multinationals who want to deal with their dividend question and not deal with the investment question.

Mr. CAUDILL. Mr. Chairman, may I comment on that?

Senator MATHIAS. Of course.

Mr. CAUDILL. The Alquist-Hughes proposed legislation in California was absolutely no solution to the worldwide unitary problem at all. It proposed that United States and foreign multinationals be taxed in this country based upon their domestic operating income plus all dividends received from foreign subsidiaries and that that income be apportioned on the basis of payrolls, sales, and property only within the United States.

I would submit to you that there is no theoretical justification for such an approach, that it is far worse even than worldwide combination because it taxes what is clearly earned by the foreign subs outside the United States and that it clearly overapportions income to the taxing State by disregarding altogether the property, payroll, and sales in foreign countries which generated that income.

Senator MATHIAS. Let me ask Mr. Clarke just one question. The interstate compact, which really was one concrete outgrowth of the Willis Commission gained a number of adherents and then some people dropped out of it. Do you know what the current box score on that is?

Mr. CLARKE. The current membership is 21.

Senator MATHIAS. What was the high water mark?

Mr. CLARKE. Twenty-two or 23. In Multistate Tax Commission there are two classes of members. One is a full member and the other is what is called an associate member. There are 21 full members and I think there are 10 associate members.

Senator MATHIAS. So there is no rush to join?

Mr. CLARKE. No.

Senator MATHIAS. Let me yield to Senator Hawkins.

Senator HAWKINS. Thank you, Mr. Chairman.

Mr. Cory, Sir Roy Denman who is head of the European Community's delegation to Washington said earlier this year that the unitary system of taxing multinational companies as adopted by some American States threatens to disrupt international investment and hinder world economic growth.

He also goes on in the same publication to state that the U.S. Supreme Court had ruled that in the absence of Federal legislation States have the right to impose unitary taxes, but admonishes States to recognize that the U.S. economy has become increasingly internationalized since the 1970's.

Would you agree that States, businesses and the U.S. economy have become increasingly internationalized since the date of the letter you read from President Reagan?

Mr. CORY. I do not think in 11 years there has been any great change. I think we were much further into an international economy than many people were aware at that time.

Senator HAWKINS. I am talking about U.S.-wide. California, I feel, has always had a disproportionate share of Japanese companies because of its location and the fact that they have a disproportionate share of Japanese-American population. Based on my reading of a lot of the documents before coming to this hearing, it appears to me that the unitary tax has a big influence on where some companies locate and where they get their employees.

Mr. CORY. Well, in terms of the international character of the rest of the Nation, I do not have the perspective to comment, but in California I do not feel that we have had any significant change since the time that letter was written.

Senator HAWKINS. Have had a significant change?

Mr. CORY. I do not feel we have had a significant change.

Senator HAWKINS. Have not had. You do not have more of an international economy today than you did in 1970?

Mr. CORY. Not significantly more, no.

Senator HAWKINS. According to the Florida unitary tax commission report which was chaired by Dean Lanzillotti, who is in the audience, their mission was to look into the Florida unitary tax. You testified that California was rethinking the concept of the unitary tax and that some audit decisions in the past may have been arbitrary and capricious.

Those are your words. What is the status of that rethinking now?

Mr. CORY. I think that any governmental official must always be rethinking and reexamining their positions. I think that is continuing. The outgrowth of that process was my support of legislation to exempt from the unitary accounting principles new plants that met certain minimal criteria for a 5-year period of time, in the hope that this relief would encourage new investment in California.

The legislature instead looked with more favor upon Governor Deukmejian's proposal of a full water's edge approach. That was not successful either, but that is the kind of rethinking that has continued since that time.

Senator HAWKINS. The United States has entered into tax treaties with most of its major trading partners, and a significant provision contained in these treaties allows a multinational corporation to seek relief from double taxation through the competent authority of the respective countries. Mr. Cory, do you believe it is reasonable for the States to be subjected to the same treaty provision?

Mr. CORY. Would you read the question again? I am not sure that I understand the significance of what I am being asked.

Senator HAWKINS. The United States has entered into tax treaties with most of its major trading partners and a significant provision contained in these treaties allows a multinational corporation to seek relief from double taxation through the competent authority of the respective countries. Is it reasonable for the States to be subjected to the same treaty provisions?

Mr. CORY. I think the United Kingdom tax treaty that was proposed, negotiated and rejected by the U.S. Senate was an attempt to explicitly deal with the unitary accounting principle and the

U.S. Senate chose not to consent in that treaty and rejected it. So I think the question has been dealt with in the past and lacking an explicit spelling out in a treaty of what the consequences are and how it is going to be carried out, well, I would really have difficulty in commenting upon it.

Mr. CLARKE. May I comment on that, Senator?

Senator HAWKINS. Please.

Mr. CLARKE. No State is seeking to be given the authority to negotiate tax treaties with foreign countries, of course. What we are saying, and we say this in the report and the position of the State administrators is very firm in this, is that when the Federal Government negotiates with the foreign partner with respect to elements concerning taxation, that they shall take into consideration the problem of State taxation.

Heretofore it has not been in the ken of the negotiators to take up the questions of the effect State taxation has on the tax treaty.

Senator HAWKINS. Why is that so?

Mr. CLARKE. Because they have never engaged in negotiations to the extent of thinking that State taxes were that important or were that much of their concern.

Senator HAWKINS. I see that you would agree that the unitary tax has caused a sudden increase of interest in this.

Mr. CLARKE. We think that by virtue of the fact that we are giving up on worldwide combined income and, therefore, impelling more review of section 482, and the need for additional information, that the tax treaties should provide the opportunity for the States to get that information, even if they get it indirectly through the Internal Revenue Service, but that the treaty shall provide for the submission of that information and use by the States, since the States have an interest in it.

We are not seeking to negotiate tax treaties individually with the States.

Senator HAWKINS. Are there any other people who would like to comment on that?

Mr. DILLON. I would just like to comment on Mr. Cory's remark that there seems to him to have been no major change in international operations in the past 10 or 11 years. Sony was, I believe, the first major Japanese electronics manufacturer to establish a plant in California. It was the first TV plant there, and that was only in 1971 when it was authorized.

In 1972, we started production. It is my calculation that that was 12 years ago. Since then we have expanded that plant considerably and other Japanese manufacturers have indeed located in California despite some of the problems on unitary tax. But we have resisted it all along. We have felt that ultimately congressional action would take care of it and, if not congressional action, that the courts would ultimately recognize that this was an impediment on international commerce that was unconstitutional.

But clearly there has been a major change in the international business community in the past 12 years.

Senator HAWKINS. Thank you.

I would like the critics of the unitary tax to go first on this question, please. I understand that the administrative burdens of complying with the unitary tax are enormous. The problem of dealing

with paperwork, relations with affiliates, subsidiaries or parent corporations, currency fluctuations, differing accounting standards, translating documents from one language to English, et cetera.

I could go on, but we are limited by time. What has been your experience regarding this problem of administrative burden?

Mr. CAUDILL. I will attempt to respond to that. For domestic-based companies, the problem is not particularly severe because everything is already expressed in U.S. dollars under generally-accepted U.S. financial and tax accounting methods.

For the foreign multinational the situation is different. In our case, our parents' books, with which BATUS is consolidated, are kept in pounds sterling using British tax and financial accounting methods. It is a severe problem for us. I would imagine in the case of a company keeping its books in yen in a foreign language as well it is much more severe.

In addition to being an administrative burden, it is also very costly to the non-U.S. company in terms of tax due on the bottom line. For example, last-in/first-out [LIFO] accounting is generally accepted for tax purposes in this country and it can result in very large tax deferrals, legitimately. It is simply a way of coping with inflation. Under British law, first-in/first-out [FIFO] is required.

Since it is absolutely impossible to go back in retrospect and put foreign operations worldwide on a LIFO basis and reconstruct 30 or 35 years of income, it means in practical terms that the foreign component of the income to be apportioned using worldwide combination must be expressed on the FIFO method, and it just tremendously inflates the foreign income and deprives the foreign multinational of the right to use last-in/first-out accounting because there is just no way to go back and reconstruct the base years and do all the double extensions and do all of the things that are required to use that method.

That could, for some industries, double or even more than double the apportionable income. So there are very major administrative problems.

Senator HAWKINS. Mr. Dillon, would you like to comment on that?

Mr. DILLON. I would certainly subscribe to what my colleague, or temporary colleague, in any event, commented. Clearly the Japanese language is one that is much more difficult to deal with even than the English language. There are major differences in accounting and in approaches to business in Japan.

I am sure we have all heard of their lifetime employment system which tends to reduce the current wages, the current salary structure, but which tends to be offset by the fact that there is more security on the job. This, of course, reduces the wage base in Japan to the detriment of our U.S. operations, where we pay competitively high labor rates or wage rates in this country which, of course, inflates the U.S. factors.

Also, many of the investments that we made in Japan in earlier times before we established a TV plant here were made when the costs in Japan were considerably below the inflated U.S. costs we have encountered in recent years. Then, of course, the currency exchange problem with the fluctuation of the yen to the dollar varying, as I noted earlier, between 176 to the dollar and 330 to the

dollar over the past several years. This bouncing around makes it clearly impossible to pursue that.

Finally, the State simply presents a bill that is based on a rather simplified approach to Sony's results, taking our results and relating them to the consolidated parent, which again is in yen. It says OK, here is the ratio; now prove us wrong. It is an incredible problem and there is no way that we can deal with all of the issues which are glossed over with that simplified approach.

Mr. CLARKE. Senator, may we have a chance to respond to that?

Senator HAWKINS. Would you like to do that in writing? We are running very short of time.

In fiscal year 1984 the unitary tax only generated 1.5 percent of the revenue collected by the States. It was \$625 million out of \$42.6 billion of the States that have a unitary tax. Now given the problems that we have known about in all of these books we have been reading, this has caused international problems with our trading partners and allies, including possible retaliatory measures, problems with disincentives to business, and problems with possible violations of the Constitution.

Does it not seem much better to repeal the law, and if a State must have additional revenue, then find some other less damaging means of doing so to international relations in light of the trade deficits that have been mentioned here today?

I would like each one of you to say yes or no.

Mr. CLARKE. I cannot say yes or no because you have so many quid pro quos and so many caveats in there. I simply say that I think we are making a fundamental error here, Senator. We are talking about the past. What the State administrators and the State proposals are, are the future.

We are not talking about worldwide combined income any more; we are talking about water's edge. And the records that were previously referred to as being in yen and so forth, no longer apply. All the records which the corporations have to submit, if we follow the principles set forth in the report are records that they have to report every year to the Internal Revenue Service.

They are not French records. They are not Italian records. They are American tax report records that go to the IRS. If the Federal Government and the State governments follow the principles as set forth in the Working Group report, the tax returns will be the water's edge tax returns that the corporations are filing with the Internal Revenue Service.

Senator HAWKINS. I am glad you brought that up because included in that task force report is a requirement that if certain disclosures were not made, there would be a presumption of unitary and any water's edge limitation would not apply.

Mr. CLARKE. Right.

Senator HAWKINS. So, would you be able to obtain from foreign affiliated companies which you do not control information such as pricing policies and key employees with knowledge of such?

Mr. CLARKE. We expect that the business community, recognizing the retreat which the States have made to water's edge, will make those records available. In addition we have already previously referred to the fact that when negotiations of treaties with foreign

partners are conducted, provisions will be made for supplying information that the States need for a proper determination of income.

Senator HAWKINS. Is it true that some data required may not even exist, U.S. tax data, for instance, that has no relevance to a foreign country's tax code?

Mr. CLARKE. Your posit was that a corporation may refuse to submit information and, therefore, the State would go back to worldwide. Well, obviously if a corporation refuses to cooperate and give the full extent and disclosure of its information, then that State should have some way to reasonably protect its tax base.

Senator HAWKINS. So if they do not have the information, or if some data does not exist, then as a result of that non-compliance through no fault of that company we would penalize them by closing the door to water's edge?

Mr. CLARKE. Not necessarily. There are negotiating principles that are set forth here. Reasonableness shall always be there. The State tax people are not unreasonable, and we work out those problems on a negotiated basis.

Senator HAWKINS [presiding]. I think it depends on whether you are paying or collecting. I do not know about reasonableness. The factor of reasonableness depends upon if you are collecting the tax or paying the tax, so I do not know that that is a very consoling factor in tax policy.

We are running close to time. I have questions from Senator Murkowski, who came for a short period of time. All of the Senators are very interested in this. There is a private briefing at this time going on for Senators on the Lebanon bombing this morning. I had mine prior to coming so that was the reason for my being a little late.

We would like to excuse you at this time. We are leaving the record open for 2 weeks for questions to be submitted to you and answers to those questions that the Senators desire. Thank you all for participating and we appreciate your traveling so far to help us weave this spider's web.

Our next panel will consist of Mr. Robert Lanzillotti, dean of the Graduate School of Business Administration at the University of Florida; Mr. Jon Shebel, president of the Associated Industries of Florida; and Ms. Mary Lou Lackey, the regional director of State relations, Motorola Inc. in Boynton Beach, FL.

We welcome you all here. Mr. Shebel, I have seen you in the back. I welcome you here. In the interest of time if you could summarize your statements and limit yourself to 5 minutes, then we will get to questions. I would like to call first on Mr. Shebel, then Ms. Lackey and conclude with Dean Lanzillotti, if you do not mind.

Mr. Shebel.

STATEMENT OF JON L. SHEBEL, PRESIDENT, ASSOCIATED INDUSTRIES OF FLORIDA, TALLAHASSEE, FL

Mr. SHEBEL. Thank you, Senator. You are very much aware of our situation in Florida, and we appreciate your concern about it.

Unitary in Florida was not adopted in the normal course that things are adopted by the Florida Legislature. As you are very much aware, it was adopted as a frantic rush to solve a political

situation which our political leaders had. The battle in effect had been over education, the funding of education. Our board of directors, which whom you are very familiar, had taken the position that if there were structural changes in education we would support tax increases.

There was an attempt to increase the rate of the corporate income tax. That battle raged for 60 consecutive days of the regular session, two special sessions, and, unfortunately, the *Container* case came down from the U.S. Supreme Court at about that time. On July 12, with very little debate, practically no research, the Governor and the legislative leaders moved through a bill that adopted the most liberal worldwide unitary method of reporting in the nation.

So just for the record, it did not happen the way it has happened in other areas, and we have started looking at it now, after we passed it. I have submitted for the record a report that just came out by Florida TaxWatch, Senator. I think this is the best thing, other than Dean Lanzillotti's report, that we have seen on the subject.

The question that we have been asked by the very distinguished trading partners that now have had to come to the State of Florida and operate, as well as dealing with the U.S. Government, is why does the United States of America permit political subdivisions to enact laws which interfere with treaties and trade relations between our Nation and other independent and sovereign nations of the world.

I guess some States get a real ego trip out of having the leaders of other nations coming by. I have met some very distinguished people from other nations, and it has been enjoyable in that sense, but certainly not under the circumstances and the price that we are paying for it.

As I said, our law is the most liberal law in the Nation, unfortunately. It has been very detrimental to our State and continues to be very detrimental to our State. Our board of directors has never gotten to the point where we have even looked at it in terms of tax equity, revenue that is coming in, and so forth, because it has been so detrimental to us. Our board has only looked at it in terms of how bad it is for the future jobs and investments in the State of Florida.

And I would respectfully submit to you that you do not get any further than that because you can spend years looking at that and, unfortunately, how bad it is is documented on a continuing daily basis.

The new plant manager of IBM who just took over from Mr. Davidson, whose letter you read into the record, Senator, made the statement in the Miami Herald yesterday that there would be no bricks and mortar in Florida by IBM until such time as unitary was repealed.

On September 18, our board of directors passed a resolution that has the effect of saying that we, a State trade association representing Florida businesses, are willing to tax all of our domestic companies with an increase in the corporate tax rate and, being parochial, that is about 99 percent of the membership of our association, to increase their tax load to take the tax load off our multina-

tional corporations. And that should give you some idea of how detrimental our board feels it is to the State.

In the TaxWatch report it says on the last page that replacement of what was anticipated by unitary—and I must tell you that nobody in the world knows what unitary tax yields in any definitive way and every commission that has met on the State and Federal level acknowledges that—but we will replace the revenue due to political necessity that is levied on us in the State of Florida by taxing ourselves to take the burden off multinational corporations who are significant employers and also Florida corporations, even though they do not happen to be headquartered there, because we feel the whole situation is so detrimental to Florida that we must do that.

So that is where we are today in Florida. We passed a resolution the day before yesterday. The Florida Chamber Board is meeting now and will be considering this matter in a resolution tomorrow. So what you have is the entire Florida business community standing up and saying we are willing to tax ourselves to get this burden off because we feel that it is hurting our State in terms of our good friends in Japan, England, Germany, and our multinational corporations all U.S.-based.

[Mr. Shebel's prepared statement and attachments follow:]

TESTIMONY OF
JON L. SHEBEL
PRESIDENT



 *Associated Industries of Florida*

TO THE
INTERNATIONAL ECONOMIC POLICY SUBCOMMITTEE
UNITED STATES SENATE FOREIGN RELATIONS COMMITTEE
ON THE
WORLDWIDE UNITARY METHOD OF APPORTIONMENT
AT
WASHINGTON, D.C.
ON
SEPTEMBER 20, 1984

MR. CHAIRMAN AND SENATORS, MY NAME IS JON L. SHEBEL AND I SERVE AS PRESIDENT OF ASSOCIATED INDUSTRIES OF FLORIDA, WHICH IS OUR STATE'S MAJOR BUSINESS ORGANIZATION WITH OVER TWO THOUSAND CORPORATE MEMBERS, WHO EMPLOY OVER 60% OF THE STATE'S PRIVATE SECTOR WORK FORCE.

WE SINCERELY APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE THE SUBCOMMITTEE THIS MORNING. UNFORTUNATELY, WE ARE HERE BECAUSE OUR LEGISLATURE AND GOVERNOR CHOSE TO ADOPT THE UNITARY METHOD OF APPORTIONMENT FOR MULTI-STATE AND MULTI-NATIONAL CORPORATIONS (HEREINAFTER REFERRED TO AS "UNITARY" OR "UNITARY TAX"). AS SENATOR PAULA HAWKINS CAN ADVISE YOU, THIS DECISION



HAS BEEN VERY DETRIMENTAL TO OUR STATE IN TERMS OF THE CREATION OF NEW JOBS AND INVESTMENTS.

PLEASE UNDERSTAND FROM THE OUTSET OF MY REMARKS THAT OUR PROBLEM IN FLORIDA IS NOT EXACTLY THE PROBLEM THAT YOU ARE DEALING WITH HERE TODAY. I WANT TO MAKE THAT DISTINCTION BECAUSE THE PROBLEM WHICH YOU ARE DEALING WITH HAS TO DO WITH THE CONDUCT OF INTERNATIONAL TRADE RELATIONS AND NOT TRADE RELATIONS BETWEEN THE STATES OF OUR NATION. AS A REPRESENTATIVE OF BUSINESS IN A STATE WHICH HAS PASSED THE UNITARY TAX, I AM VERY MUCH AWARE OF THE STRONG, ADVERSE FEELINGS OF OUR FOREIGN TRADING PARTNERS AND OUR VERY GOOD FRIENDS, SUCH AS JAPAN, GERMANY, ENGLAND, THE NETHERLANDS, ETC. THEY HAVE NOT ONLY BEEN VOICING THEIR SERIOUS CONCERN IN WASHINGTON, BUT HAVE COME TO THE STATE OF FLORIDA AND OTHER STATES WHERE THE UNITARY TAX HAS BEEN ENACTED. THEIR QUESTION TO US IS VERY LOGICAL: "WHY DOES THE UNITED STATES OF AMERICA PERMIT POLITICAL SUBDIVISIONS TO ENACT LAWS WHICH INTERFERE WITH TREATIES AND TRADE RELATIONS BETWEEN OUR NATION AND OTHER INDEPENDENT AND SOVEREIGN NATIONS OF THE WORLD?" IT IS OBVIOUS TO ALL OF US THAT OUR FEDERAL GOVERNMENT IS CONSTITUTIONALLY RESPONSIBLE FOR TRADE RELATIONS WITH FOREIGN NATIONS, AND THE STATES SHOULD NOT BE PERMITTED TO DELVE INTO THIS AREA.

THIS MAY SOUND STRANGE COMING FROM ONE WHO REPRESENTS PEOPLE WHO STRONGLY BELIEVE IN STATES' RIGHTS; BUT, THERE ARE



THOSE THINGS THAT SHOULD BE RESERVED TO THE PREROGATIVE OF THE FEDERAL GOVERNMENT, AND FOREIGN TRADE RELATIONS IS, IN OUR OPINION, DEFINITELY AMONG THOSE TYPE THINGS. THEREFORE, WE WOULD STRONGLY ENDORSE FEDERAL LEGISLATION TO PRECLUDE THE STATES FROM ESTABLISHING POLICIES RELATING TO THE TAXATION ON A UNITARY BASIS FOR BOTH UNITED STATES AND FOREIGN BASED CORPORATIONS. WE TOTALLY AGREE THAT THERE SHOULD BE A COMPETITIVE BALANCE FOR UNITED STATES MULTI-NATIONAL CORPORATIONS, FOREIGN MULTI-NATIONAL CORPORATIONS AND PURELY DOMESTIC CORPORATIONS.

WHAT WE ARE TALKING ABOUT IN FLORIDA GOES FAR BEYOND WHAT I HAVE JUST STATED. THE FLORIDA LEGISLATURE ON JULY 12, 1983, PASSED SB 3C WHICH PLACED FLORIDA IN THE POSTURE OF HAVING THE MOST LIBERAL LAW IN THE NATION WITH REGARD TO THE UNITARY TAX. SINCE THAT TIME, OUR ASSOCIATION HAS TAKEN THE LEAD IN ATTEMPTING TO HAVE THIS LAW REPEALED. THIS NEW FLORIDA LAW DOES NOT JUST RELATE TO TAXATION OF INCOME OUTSIDE THE UNITED STATES, BUT RELATES TO TAXATION OF INCOME IN OTHER STATES OF OUR NATION AND THOSE RELATING TO BUSINESS WITH THE FEDERAL GOVERNMENT.

WHILE THE "WATER'S EDGE APPROACH" IS ONE WHICH WE WOULD ENDORSE WITH REGARD TO ACTION BY THE CONGRESS, WE MUST GO MUCH FURTHER WHEN DEALING WITH THE GOVERNOR AND THE FLORIDA LEGISLATURE BECAUSE WE HAVE FOUND THAT THOSE COMPANIES, BOTH UNITED STATES AND FOREIGN MULTI-NATIONALS, ON WHOM WE DEPEND TO PLACE NEW JOBS AND INVESTMENTS IN OUR STATE FEEL VERY NEGATIVELY



TOWARDS A UNITARY LAW IN FLORIDA EVEN IF IT FOLLOWS ONE OF THE "WATER'S EDGE" APPROACHES.

NOW I WOULD LIKE TO TELL YOU WHY AND HOW FLORIDA BECAME A UNITARY STATE. PLEASE REST ASSURED THAT WE DID NOT MOVE INTO THIS ARENA BASED ON LOGIC BUT RATHER FRANTICALLY JUMPED IN WITHOUT PROPER RESEARCH OR THOUGHT.

THE 1983 SESSION OF THE FLORIDA LEGISLATURE WAS VERY SERIOUS ABOUT IMPROVING THE QUALITY OF EDUCATION IN OUR STATE. THE GOVERNOR AND THE LEGISLATURE ARE TO BE COMMENDED FOR THEIR EFFORTS TO ENHANCE OUR EDUCATIONAL SYSTEM; HOWEVER, WHAT TRANSPIRED SHOULD BE A LESSON TO ALL OF US THAT THERE ARE THOSE TIMES WHEN ONE SHOULD TAKE A LITTLE TIME TO MAKE SURE THINGS ARE DONE CORRECTLY. THERE WERE A CONGLOMERATION OF BILLS BEFORE THE LEGISLATURE, NONE OF WHICH SPOKE TO THE BASIC RESTRUCTURING OF THE SYSTEM WITH REGARD TO TEACHERS. ASSOCIATED INDUSTRIES OF FLORIDA SOUGHT TO HAVE PASSED A PERFORMANCE-BASED SYSTEM (HEREINAFTER REFERRED TO ON OCCASION AS "MERIT PAY") FOR CLASSROOM TEACHERS. IN ADDITION, IT WAS OUR GOAL TO PLACE THE INDIVIDUAL SCHOOL PRINCIPAL BACK IN CHARGE OF THE SCHOOL BY HAVING THEM SOLELY RESPONSIBLE FOR EVALUATING THE CLASSROOM TEACHERS WITH REGARD TO THEIR QUALIFICATIONS FOR MERIT PAY.

THE GOVERNOR AND SOME LEGISLATIVE LEADERS REJECTED THE IMPLEMENTATION OF A VALID MERIT PAY PLAN, ALTHOUGH THEY DID COME FORTH WITH A PLAN WHICH BUSINESS FELT WAS INVALID AND CONTINUED



TO ATTEMPT TO RAISE THE CORPORATE INCOME TAX RATE TO FUND ACROSS-THE-BOARD PAY RAISES FOR TEACHERS. THIS IS ESSENTIALLY AND IN REALITY WHAT THE BATTLE WAS ALL ABOUT IN FLORIDA. THE BATTLE BETWEEN BUSINESS, WHICH WANTED MERIT PAY AND POWER FOR THE PRINCIPAL, AND THE GOVERNOR AND SOME LEGISLATIVE LEADERS, WHO WERE NOT WILLING TO GO THIS FAR BUT RATHER WANTED BUSINESS TAX INCREASES FOR ACROSS-THE-BOARD PAY RAISES, RAGED THROUGHOUT THE SIXTY-DAY REGULAR SESSION IN 1983 AND CARRIED OVER INTO TWO SPECIAL SESSIONS WITH THE RESULT THAT NO TAX INCREASE BILLS WERE PASSED.

THEN ALONG CAME THE CONTAINER DECISION WHICH RULED THAT CALIFORNIA'S UNITARY TAX WAS CONSTITUTIONAL. WITHIN TEN DAYS OF THE ISSUING OF THE CONTAINER DECISION, THE LEGISLATURE PASSED A UNITARY LAW IN FLORIDA. IN ESSENCE, FLORIDA TURNED TO UNITARY SIMPLY BECAUSE OTHER TAX INCREASES COULD NOT BE PASSED. THIS NEEDS TO BE UNDERSTOOD BECAUSE THE FLORIDA LEGISLATURE HAS A REPUTATION NATIONWIDE FOR DETAILED RESEARCH AND INVESTIGATION PRIOR TO ACTION.

SINCE THE PASSAGE OF THE UNITARY TAX LAW IN FLORIDA ON JULY 12, 1983, THERE HAS BEEN A MASSIVE EFFORT TO TOTALLY REPEAL THIS LAW, AND I NOW FEEL MORE CONFIDENT THAN EVER THAT IT WILL BE REPEALED. THE INCOMING SPEAKER OF THE HOUSE AND PRESIDENT OF THE SENATE (PRESIDING OFFICERS SERVE FOR TWO YEARS IN FLORIDA AND THE NEW SPEAKER AND PRESIDENT WILL TAKE OFFICE IN NOVEMBER, 1984)



HAVE MADE IT VERY CLEAR THAT THEY SEEK TO REPEAL THE UNITARY TAX AND REPLACE LOST REVENUES, IF ANY, WITH OTHER BUSINESS TAXES. THIS HAS BEEN A MAJOR CONTROVERSY SINCE SOME PEOPLE FEEL THAT THERE, IN FACT, WILL BE NO REVENUE LOST WITH THE REPEAL OF UNITARY (SEE ENCLOSED REPORT BY FLORIDA TAXWATCH, INC., ENTITLED "THE UNITARY TAX: FLORIDA'S ALBATROSS - DOES IT ADD UP?") IT IS ANTICIPATED THAT THERE WILL BE A SPECIAL SESSION IN DECEMBER, 1984, AT WHICH TIME THE LEGISLATURE WILL REPEAL THE UNITARY TAX. IN FLORIDA, THE GOVERNOR HAS A VETO OVER LEGISLATIVE ENACTMENTS AND, FRANKLY, IT IS SOMEWHAT UNCLEAR NOW AS TO THE GOVERNOR'S EXACT POSITION ON THE REPLACEMENT REVENUE PACKAGE, ALTHOUGH THE GOVERNOR IS ON RECORD AS SUPPORTING REPEAL OF THE UNITARY TAX AND HAS AT VARIOUS TIMES SUPPORTED THE COMPONENTS OF THE REPLACEMENT PACKAGE.

MULTI-NATIONAL CORPORATIONS AND FLORIDA-BASED BUSINESSES HAVE GONE TO THE WALL AND BEEN EXTREMELY REASONABLE IN THEIR EFFORTS TO REPEAL UNITARY. BUT THE BOTTOM LINE IS, TO REPEAL UNITARY WILL MEAN THAT MULTI-NATIONAL CORPORATIONS WHO ARE NOW PAYING MORE BECAUSE OF UNITARY WILL PAY LESS AND FLORIDA-BASED CORPORATIONS WHO ARE NOT AFFECTED BY UNITARY, WHICH IS THE VAST MAJORITY OF THE COMPANIES IN OUR STATE, WILL BE ASKED TO PAY MORE TAXES TO GET RID OF UNITARY. TO SHOW YOU HOW STRONGLY BUSINESS PEOPLE FEEL ABOUT THE ADVERSE EFFECTS OF THE UNITARY METHOD OF TAXATION, I HAVE ATTACHED A RESOLUTION OF THE BOARD OF DIRECTORS OF ASSOCIATED INDUSTRIES OF FLORIDA, WHICH WAS ADOPTED THIS PAST



TUESDAY, SEPTEMBER 18, WHICH IN EFFECT STATES THAT IF THE FUNDS ARE NEEDED, FLORIDA-BASED BUSINESSES WILL PAY INCREASED TAXES TO LOWER THE TAX LIABILITY UNDER UNITARY FOR MULTI-NATIONAL CORPORATIONS. WHEN YOU CONSIDER THAT OUR BOARD OF DIRECTORS IS COMPOSED PRIMARILY OF FLORIDA-BASED EMPLOYERS AND THAT OUR MEMBERSHIP IS FOR THE MOST PART FLORIDA-BASED EMPLOYERS, AND THAT OUR BOARD OF DIRECTORS HAS VOTED FOR ADDITIONAL TAXATION ON THEMSELVES AND PROBABLY 95% OF OUR OTHER MEMBERS TO GET RID OF THE UNITARY TAX, THEN YOU CAN UNDERSTAND HOW NEGATIVE AN IMPACT THIS TAX HAS ON A STATE.

ATTACHED ARE DOCUMENTS WHICH WILL PROVIDE YOU WITH ADDITIONAL INFORMATION ON THE UNITARY TAX IN FLORIDA. A "SPECIAL NOTICE" OF JUNE 15, 1984, TO OUR BOARD OF DIRECTORS PROVIDES YOU WITH A STEP-BY-STEP ANALYSIS OF WHAT HAPPENED DURING OUR 1983 AND 1984 SESSIONS OF THE LEGISLATURE. THE REPORT OF SEPTEMBER, 1984, BY FLORIDA TAXWATCH, INC., ENTITLED, "THE UNITARY TAX: FLORIDA'S ALBATROSS - DOES IT ADD UP?" IS PROBABLY THE FINEST COMMENTARY ON OUR UNITARY TAX THAT I HAVE SEEN, AND I COMMEND IT TO YOUR READING.

IN SUMMARY, ALL I CAN SAY IS THAT ANY STATE WHICH ADOPTS THE UNITARY METHOD OF TAXATION AS A STATE LAW WILL BE SORRY. IN ADDITION, I SIMPLY AGREE WITH ALL OUR TRADING PARTNERS OVERSEAS THAT THE UNITED STATES OF AMERICA SHOULD NOT PERMIT THE INDIVIDUAL STATES TO ENGAGE IN FOREIGN COMMERCE ON THEIR OWN.

THANK YOU VERY MUCH FOR PROVIDING US WITH AN OPPORTUNITY TO APPEAR BEFORE THE SUBCOMMITTEE TODAY, AND I WILL BE PLEASED TO ANSWER ANY QUESTIONS.

Resolution



OF THE

BOARD OF DIRECTORS

OF

Associated Industries of Florida

- WHEREAS, the primary goal of the Governor and the legislative leadership during the 1983 Session of the Legislature was purported to be the upgrading and enhancing of the educational system of Florida, particularly the levels of K-12; and,
- WHEREAS, Senate President Curtis Peterson personally filed the RAISE bill, which was essentially the report of the Governor's Commission on Secondary Schools for the State of Florida (January, 1983), on which Commission the President had so diligently served; and,
- WHEREAS, the RAISE bill upgraded the requirements levied on the K-12 students with particular emphasis on math, science and English composition and was indeed a very positive and landmark piece of legislation which was totally supported by Associated Industries of Florida and which ultimately passed the Legislature; and,
- WHEREAS, according to Senator Peterson, who was throughout almost the entire session opposed to significant new taxes being imposed, the RAISE bill required very small tax increases; and,
- WHEREAS, Governor Bob Graham and Speaker of the House Lee Moffitt proposed less defined education programs which required significant tax increases; and,
- WHEREAS, Speaker Moffitt proposed an increase in the corporate income tax rate from 5 percent to 7 percent but proposed no valid program to fund; and,
- WHEREAS, the Board of Directors of Associated Industries of Florida met with the Governor and the Speaker and urged them both to come forth with plans to implement a performance-based pay system for teachers (commonly referred to as merit pay) and to place the individual school principal back in a true position of authority; and,
- WHEREAS, on May 16, 1983, both the Governor and the Speaker delivered proposed merit pay programs to Associated Industries of Florida, neither of which could be considered to effectively measure performance and be the basis of merit compensation; and,



- WHEREAS, Associated Industries of Florida respectfully recommended to the Governor and the Speaker that a working group be formed consisting of business leaders, teachers, school administrators, parents and state governmental officials to work on an around-the-clock basis to produce the specific language to implement by statute a workable merit pay program; and,
- WHEREAS, the Governor and the Speaker both rejected this approach and moved forward to increase taxes to provide across-the-board pay raises to teachers without a workable merit pay plan; and,
- WHEREAS, during this same time period the President of the Senate was opposing significant new tax burdens being imposed; and,
- WHEREAS, during this time period Associated Industries of Florida was opposing the levying of additional tax burdens of any type but at the same time making it clear that the Association would assist in raising new tax dollars at such time as statutory language was passed to implement a workable merit pay program and place the individual principal back in charge of the school; and,
- WHEREAS, the 1983 Regular Session came to an end without additional taxes being imposed as did two subsequent special sessions; and,
- WHEREAS, the Governor called Special Session "C" on July 7, 1983, within ten days of the rendering of the Container Corporation of America v. Franchise Tax Board decision by the United States Supreme Court which held California's unitary law constitutional; and,
- WHEREAS, Senate Bill 3C was filed for consideration which proposed, among other things, adoption of the unitary method of apportionment for multistate and multinational corporations, removal of the foreign source income exclusion, adoption of the "throwback rule" and disallowance of the apportionment of non-business income; and,
- WHEREAS, the Legislature passed Senate Bill 3C on July 12, 1983, without adequate analysis and testimony as to the impact of the unitary method of apportionment from a tax policy or fiscal policy point of view and the Governor thereafter signed the bill into law; and,
- WHEREAS, after the passage of Senate Bill 3C it became obvious during the course of the next year that from the tax policy and fiscal policy points of view that the unitary tax was definitely not in the best interest of Florida in terms of the creation and continuation of jobs and investments; and,
- WHEREAS, the Government met with a cross section of business organizations, including Associated Industries of Florida, during the last week of the 1984 Session of the Legislature and then proposed a tax package of business taxes as replacement for the corporate tax provisions which became law with the passage of SB 3C during the 1983 Session; and,
- WHEREAS, this package was filed as SB 1010 which replaced the corporate tax provisions of SB 3C; and,



WHEREAS, SB 1010 passed the Florida Senate on June 1, 1984, by a vote of 38 to 1; and,

WHEREAS, the bill was amended on June 1, 1984, by the Florida House of Representatives and said amendment would have increased the rate of the corporate income tax by one-half of one percent; and,

WHEREAS, Associated Industries of Florida opposed the bill when it returned to the Senate because of the House Amendment; and,

WHEREAS, the 1984 Session ended on June 1, 1984, without the Senate taking the bill, as amended, up for consideration; and

WHEREAS, also on June 1, 1984, the Legislature passed a valid merit pay bill and language to place the individual school principal in a position of authority but such action was unknown to almost everyone until the next day because this action was taken on the final day of the session which is always frantic, to say the least; and

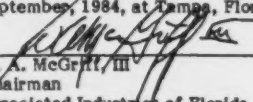
WHEREAS, the Board of Directors of Associated Industries met on June 18, 1984, and voted to "consider" a one-half of one percent increase in the corporate income rate because of the Legislature's positive action on the merit pay and principal's authority issues; and

WHEREAS, the incoming legislative leaders, Senate President-Designate Harry Johnston and House Speaker-Designate James Harold Thompson, have announced their desire to repeal the unitary approach and replace the revenues with an increase of one-half of one percent in the rate of the corporate income tax at a Special Session of the Legislature to be held in December, 1984;

NOW, THEREFORE, BE IT RESOLVED BY THE BOARD OF DIRECTORS OF ASSOCIATED INDUSTRIES OF FLORIDA:

That the Board of Directors of Associated Industries of Florida supports repeal of the corporate tax provisions of Senate Bill 3C passed by the Legislature on July 12, 1983, and the replacement of lost revenue, if in fact the Legislature determines there will be lost revenues, by enacting into law SB 1010 as passed by the Florida Senate and thereafter amended by the House of Representatives on June 1, 1984.

I hereby certify that this Resolution was adopted by the Board of Directors of Associated Industries of Florida on the 18th day of September, 1984, at Tampa, Florida.


 W. A. McGriff, III
 Chairman
 Associated Industries of Florida



Special

NOTICE

Associated Industries of Florida

P. O. Box 784 • Tallahassee, Florida 32302-0784 • Phone (904) 224-7173

MEMORANDUM

TO: BOARD OF DIRECTORS, ASSOCIATED INDUSTRIES OF FLORIDA
 FROM: JON L. SHEBEL, PRESIDENT *JS*
 SUBJECT: TAXATION, MERIT PAY AND THE UNITARY METHOD OF TAXATION
 DATE: JUNE 15, 1984

The purpose of this memorandum is to recount the activities of Associated Industries as they relate to the issues of education and taxation starting with the 1983 Session of the Legislature and coming forward until today.

During the 1983 Session, it became obvious early in the session that the primary goal of the leadership of the House and the Senate was to enact legislation to revamp and upgrade the educational system in the State of Florida with primary emphasis on K-12. Senate President Curtis Peterson (D-Lakeland) came forth with the RAISE bill which was essentially the report of the Governor's Commission on Secondary Schools for the State of Florida (January, 1983). President Peterson had served as a very active member of the Governor's Commission and had been one of the leaders in the Legislature for many years in the education area. This bill basically upgraded the requirements levied on students with particular emphasis on the areas of math, science and English composition. The bill ultimately passed the Legislature as probably one of the landmark, if not the landmark, pieces of legislation in the educational area for several decades. The additional cost of President Peterson's legislation was very small; and throughout most of the session, the Senator opposed additional taxes, which were being advocated in the House of Representatives. The Board supported President Peterson's bill throughout the Session.

Speaker of the House Lee Moffitt (D-Tampa), during the 1983 Session, announced that his primary program would be the upgrading of education. The Speaker had a much less defined program than that of President Peterson's; and his program ultimately became a group of proposals which were put together, basically at the last minute, to project his views as to what should be done in the educational area.

Governor Bob Graham also had an extensive education program and was one of the major proponents of education during his legislative service. The Governor's program differed greatly from the programs of the House and Senate; and, as usual, when the House, Senate and Governor all have different approaches to a major area of legislation, the legislative bodies take up their own proposals, which happened in 1983. There was a significant amount of the Governor's input contained in the proposals as they moved through the Legislature; but for the purposes of this memorandum, I will primarily confine my discussion to the House and Senate proposals.

As you will all recall, the Board of the Association became very interested in the education reform area; and we requested that Dr. B. Frank Brown, a noted educational consultant who served as the Chairman of the Governor's Commission, advise us as to what should be done by the Legislature to enhance the educational system. Our major discussions in this area revolved around the report of the Governor's Commission, which, as I have already stated, was primarily the bill offered by President Peterson.

The Board almost from the outset was unanimous in wanting to develop a system which would enable school teachers to be paid based on their performance. In addition, the Board felt that current laws and practices had left the individual schools in a basically leaderless situation, since the power of the principal was severely limited. In this regard, it was the Board's feeling that the principal should be placed back in charge at each of the state's schools.

The Board of Directors had met on the day prior to the opening of the 1983 Session of the Legislature and had directed the staff to issue a press release stating that the Board had unanimously adopted a position to oppose any and all tax increases during the 1983 Session of the Florida Legislature. In the press release, Chairman of the Board T. Wayne Davis stated that "Associated Industries of Florida was out front to increase the sales tax in 1982 and fuel and license tag taxes because business people felt additional funding was necessary for education, transportation and law enforcement." Chairman Davis pointed out these taxes would bring in over \$1 billion in new revenue annually to the state. This release caused a sharp reaction from the Governor's staff which charged that Associated Industries was coming out "...against quality education..." The Governor requested a meeting with the Board of Directors, which took place on April 26, 1983.

Prior to the meeting with the Governor on April 26, 1983, the Board met for three hours with Dr. B. Frank Brown and a noted budget expert from the Citizens Council for Budget Research. After three hours of briefings and discussions, the Board adjourned and proceeded to the Governor's conference room, where it met with the Governor, the Chief of Staff, the Deputy Chief of Staff and the Governor's Senior Advisor. The Governor made a short statement urging the Board to support additional funding for education during the 1983 Legislative Session. Individual board members engaged in dialogue with the Governor; and the message from each of those speaking and the Board collectively was — The State must go to a merit pay system and there must be a major restructuring of the system, without which additional dollars would not result in the desired enhancement of our educational system. It was clear from this meeting that the Board totally supported the establishment of an outstanding educational system, but it was also

very clear that the Board felt there would be no significant change without a restructuring of the basis for teacher pay, such as a workable merit pay system. The Governor listened to each of the director's comments, but made no comment of his own regarding a performance or merit pay system. After the meeting with the Governor, the Board reconvened at the Associated Industries office to discuss the meeting. In my opinion, there was a consensus among Board members present at the meeting with the Governor that he did not appear to be very interested in our proposal since he did not comment or otherwise express himself. As it turned out, the Governor was interested, as will be outlined later herein.

On May 13, 1983, Speaker Lee Moffitt called me to his office and I met with him and Representative Herb Morgan, Chairman of the House Appropriations Committee, for almost two hours. The Speaker advised me during this meeting that he wanted to raise the corporate income tax rate from 5% to 7% to "...enhance education..." but knew without business support he could not pass the increase in the rate. I advised the Speaker of our Board's position of no new taxes during the 1983 Session and of our Board's attitude that the educational system must be changed to reward teachers based on their performance (merit pay), which is designed to eliminate teachers who are not qualified to be in the classroom. The Speaker agreed that this was the direction in which we must direct our collective efforts and requested to address the Board. On May 13, 1983, at 10:00 a.m., a meeting of the Board of Directors convened by teleconference. Speaker Moffitt came on the line and made a presentation to the Board in which he basically outlined those things which he said during my meeting with him on May 11. The Speaker stated he would deliver his plan for a merit pay system to our office on May 16. The plan was delivered on the same day on which the Governor released his merit pay plan. Hence, both the Speaker and the Governor had come forth with what they considered to be merit pay programs. Unfortunately, the plans, which were very similar, were more of a step or bonus program and were not plans which could be considered to effectively measure performance and base compensation on same. We respectively advised the Governor and the Speaker that we did not feel their programs contained the necessary criteria on which a merit program could be based. It was suggested to the Governor and the Speaker that a working group be formed consisting of business leaders, teachers, school administrators, parents and state governmental officials to work on an around-the-clock basis and bring forth the specific language to implement by statute a workable merit pay program. Associated Industries of Florida respectfully advised the Speaker and the Governor that a performance-based program for school teachers could not possibly be developed overnight and any program that would be fair to the 92,000 school teachers and the people of Florida must be put together properly and implemented all at one time. Both the Speaker and Governor rejected this approach and continued to move forward to increase taxes in order to provide across-the-board pay raises to teachers without changing the system.

On May 18, 1983, the House Finance & Taxation Committee passed an education bill which increased the rate of the corporate income tax from 5% to 7%. The Committee Chairman did not permit any presentations by anyone from the general public, and copies of the bill were not available until the meeting started.

Associated Industries sent a letter to Senate President Curtis Peterson on May 20, 1983, in which we outlined our meetings with the Governor and Speaker Moffitt relating to merit pay. The letter advised the President that "The Board further directed me (Shebel) not to discuss any additional tax revenues until such time as an acceptable bill is developed to redirect and upgrade the educational system of our state. The Board reasoned that if taxes were discussed prior to the development of the bill, this would be the same as purchasing a manufactured product prior to knowing anything about the product, much less seeing it." The letter then went on to advise the President that while we supported his RAISE bill and commended him for his sponsorship of the bill that "...the Board is still opposed to any and all new taxes..." until significant changes are made in the system, such as the merit pay approach. This letter was written to the President of the Senate at his request since at that time he was opposing any and all new taxes.

On May 22, 1983, I sent a memo to the Board of Directors advising that the Florida Chamber and the Florida Council of 100 had requested a meeting with a committee of the Board of AIF in Tampa on May 23. Chairman Davis requested Messrs. Bostick, Kercher, Rankin, Zagorac and Shebel to attend the meeting on behalf of the Association. The Florida Chamber was represented by Messrs. Becker (President), Dwyer, Wright and Ryll; The Florida Council of 100 by Messrs. Culbreath (President), Bronson (Chairman of the Education Committee), Dover, Drake and Linder. The meeting of the AIF Board was called for the afternoon of May 23 so the Board could listen to any proposals brought forth by the Chamber or the Council. It is important to understand at this point that neither the Chamber nor the Council had kept up with the education/taxation battle on a day-to-day basis. At the Tampa meeting, it became obvious that the staffs of the Chamber and the Council of 100 did not really know exactly what was going on with regard to the situation in Tallahassee. In my memorandum of May 22, 1983, I expressed concern that some political leaders were attempting to get AIF into an agreement with some other major business organizations as to a position and then have the other organizations change their minds and leave AIF hanging on a limb alone.

At the meeting in Tampa on May 23, 1983, a joint statement was drafted by the three business organizations and was approved by the representatives of the Council and the Chamber. I advised the participants that AIF could not agree on any position until the Board of Directors had approved said position. At our teleconference Board meeting on the afternoon of May 23 the "Joint Position of Associated Industries of Florida, The Florida Chamber and The Florida Council of 100 on Education" was adopted. This statement was released to the news media on May 24, 1983. (A copy of this joint statement is enclosed).

On May 25, 1983, the House of Representatives passed CS/CS/SB 357 which encompassed the House approach to fund additional dollars into the educational system by an increase in the corporate income tax of 40% (from 5% to 7%). The vote in the House was 93-25. The Senate refused to go along with the increase in the corporate income tax rate.

On May 31, 1983, the Florida Chamber, without advising Associated Industries, backed out from the joint statement which had been agreed to at the meeting on May 23 in Tampa. The Florida Council of 100 later announced basically the same position. Associated Industries was left standing alone in opposition to new taxes without a proper program.

The Regular Session came to an end in 1983 with a deadlock due to the fact that those who were advocating additional taxes which would be used primarily for across-the-board pay raises to teachers were thwarted in every attempt they made to raise new tax dollars. After several special sessions, a quirk of fate brought forth a United States Supreme Court decision involving Container Corporation of America which declared that the unitary approach to corporate taxation, as had been used in California for many years, was constitutional. By this time the Governor and legislative leaders were frustrated; and they simply reached out, grabbed this new approach and almost overnight passed the unitary approach (July 12, 1983) and adjourned. There was very little time for comment by anyone, and no one had an opportunity to see the proposed legislation until the very last minute. In my opinion, there was no intent or design by any of our governmental leaders to cause this serious problem which has evolved with regard to the image of Florida by multinational corporations.

Since July 12, 1983, Associated Industries of Florida and many other organizations have advocated repeal of the unitary approach. During the 1984 Session, legislators and the Governor were lobbied heavily to repeal the unitary approach. The Governor stated that he would consider repeal if the business community would come up with replacement dollars from business-based taxes. With one week left in the legislative session, the Governor agreed to sit down and discuss replacement revenues with business representatives. Enclosed is a copy of this "Senate Staff Analysis and Economic Impact Statement" of Proposed CS/SB 1010 which outlines the proposal which the Governor accepted relating to replacement revenue. This bill passed the Senate by a vote of 38-1 on the last day of the Session and was sent to the House of Representatives. The incoming Speaker (Representative James Harold Thompson) objected to the provision in the replacement revenue bill which would have increased the annual corporate filing fees on Florida corporations. It was Representative Thompson's suggestion that this bill unduly taxed small Florida corporations to eliminate taxation from large multinational corporations. Associated Industries argued that this was not the case since employers who employ from 1 to 50 employees would not have their tax increased. Notwithstanding our pleadings, Representative Thompson came out on the last day of the session with an approach for replacement revenue that envisioned an increase in the corporate income tax rate by 1%. Associated Industries and others in the final hours of the session opposed this approach in the Senate; and the Senate simply did not take the bill up, which caused the unitary approach not to be repealed.

Since the session ended, I have spent a lot of time talking with Deputy Chief of Staff Charlie Reed in an effort to encourage the Governor to come out with a positive statement that he would call a special session to repeal the unitary approach at such time as the House, Senate and the business community could agree to exactly what the replacement package would be. It is obvious from the vote in the Senate (38-1) and the vote in the House (99 representatives voted for repeal on the passage and 18 against —

there probably would have been more voting for repeal on final passage except some of the members objected to the rate increase as a replacement revenue). It is obvious that the Legislature overwhelmingly desires to repeal the unitary approach and replace it with other business-based taxes. The Governor also desires repeal.

I believe it is very clear the stage is now set for repeal of the unitary approach. The problem is no longer whether or not unitary should be repealed, but what the replacement revenue package will encompass.

On Wednesday, June 13, the Governor in a discussion with some reporters (see enclosed newspaper articles) talked about a "graduated corporate income tax rate." This is an approach used in a number of states whereby the rate of the corporate income tax is higher for corporations which make higher profits and lower for corporations making lower profits. Listed below are examples of "graduated rates" utilized in the Southeastern states and the flat rates of the other Southeastern states.

CORPORATE TAX RATES FOR SOUTHEASTERN STATES WITH GRADUATED SCALES

ARKANSAS

1st \$3,000	1%
2nd \$3,000	2%
Next \$5,000	3%
Next \$14,000	5%
Over \$25,000	6%

KENTUCKY

\$25,000 or less	3%
Next \$25,000	4%
Next \$50,000	5%
Over \$100,000	6%

LOUISIANA

1st \$25,000	4%
Next \$25,000	5%
Next \$50,000	6%
Next \$100,000	7%
Over \$200,000	8%

MISSISSIPPI

1st \$5,000	3%
Next \$5,000	4%
Over \$10,000	5%

NOTE: The following Southeastern states have a flat rate corporate tax:

Alabama	5%
Florida	5%
Georgia	6%
North Carolina	6%
South Carolina	6%
Tennessee	6%

For the last taxable year in Florida, there were approximately 144,000 corporations. There were 34,000 corporations that actually paid some corporate income tax during the last taxable year. This means that the remainder of the 110,000 either did not make more than \$5,000 in net profit (the exemption) or they simply did not file a corporate income tax return. Also, during the last taxable year, 90% of the dollars paid in corporate taxes (\$500,000,000) were paid by 10% of the corporations paying the tax. In addition, less than 1% of the corporate taxpayers in Florida pay over 50% of corporate taxes collected. It is obvious when reviewing these figures and looking at a "graduated rate" on the corporate income tax that it would be politically expedient for the Legislature to constantly increase the rate on the largest taxpayers while leaving the rate the same or even reducing it on the smaller taxpayers. For Florida domiciled corporations, this could become the same type burden as the unitary approach has been for the multinational corporations. In addition, this could end up costing multinational corporations as much or more money than the unitary approach. I believe that the Governor's mention of a "graduated rate" interjects a new and negative feature into this entire situation and one which deserves very serious consideration.

On the positive side, I am pleased to be able to report that the Legislature, in the final hours (late Thursday night) finally "got it done" with regard to the merit pay issue. (Please read pages 942-945, Sections 17 and 18 of the "Journal of the Senate" of June 1, 1984, which is enclosed). Basically, the principal is now in charge of the school; and teachers will, as soon as tests are developed, be required to prove their proficiency in their subject areas to qualify for merit pay. In addition, the meritorious school approach within each district is inserted. This basically implements the suggestions of the Florida Quality Instruction Incentives Council which included in its membership business leaders such as Dr. Joe A. Boyd, Mr. Tommy E. Bronson, Mr. Bill Dwyer, Mr. Phil Lewis, and Mr. Marshall McDonald. These gentlemen and the other members of the Council worked diligently to develop an excellent report, and the Legislature has basically implemented the report.

I think it is appropriate at this point to look back at 1983 and realize that the House of Representatives was advocating an increase in the corporate income tax from 5% to 7% to basically fund across-the-board pay raises. The Speaker refused to slow down enough to implement a valid merit pay program. Today, just a little short of a year later, we are in a position of having implemented a valid basis for merit pay and being able to "buy out" the unitary tax if the business community, the Senate, the House and the Governor can agree on the appropriate business-based revenue sources. I recommend that this be our point of discussion at the teleconference Board meeting scheduled for Monday, June 18, 1984.



ANALYSIS

Sept. 1984

THE UNITARY TAX: Florida's Albatross Does it add up?

Formerly Citizens Council for Budget Research, Inc.

Florida **TaxWatch**, Inc. is the only statewide organization devoted entirely to Florida taxing and spending issues. Since its inception in 1979, **TaxWatch** has worked diligently and effectively to safeguard the interests of the taxpayer, helping to reduce inefficiencies and prompting responsible cost effective improvements in the management and operation of citizens' tax dollars.

TaxWatch is supported by all types of taxpayers — homeowners, small businesses, large corporations, professional firms, members of the news media, associations and individuals — representing a wide spectrum of Florida's citizens. **TaxWatch** is a non-partisan, non-profit research and public information organization supported entirely by voluntary tax deductible membership contributions. Membership is open to any organization or individual interested in supporting sound research which promotes effective and efficient government.

TaxWatch publishes several types of research products which range from detailed research findings and recommendations as to where and how productivity improvements in government can be achieved, to explaining how timely economic, financial and tax related developments may impact on Florida's citizens.

TAXWATCH DOES NOT OPPOSE ALL TAXES ... but is ever present to watch that taxes are fair, equitable, not excessive, that their public benefits and costs are weighed, and that government agencies are responsible and efficient in their use of public funds.



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September 1984

Dear Taxpayer:

Over the last year, much debate has centered around Florida's enactment of unitary taxation. We are sending you this *TaxWatch* analysis, "The Unitary Tax: Florida's Albatross - Does it add up?", which illustrates why unitary's basic revenue estimating assumptions are faulty and why major perceptual and procedural problems exist when a more informed and deliberative process of lawmaking is avoided. Although the unitary tax most directly adversely affects relatively few corporations, it also impacts the operations of Florida business suppliers and customers transacting business with these firms as well as casts a shadow on the state's entire business climate.

The Florida Legislature created an albatross when it passed the unitary tax (Senate Bill 3C). Due to the "need to get something done" the Governor and Legislature reacted too quickly, not allowing for the careful deliberation or sufficient public input that should be afforded a major revision of Florida's tax code. This haste has led to problems and, most importantly, has created a very negative perception, whether rightly or wrongly, of Florida's once highly receptive business climate from business and financial communities both within and outside the state.

The revenue estimates for the new law far overstated unitary's revenue capacity, especially in the first years of implementation. Due to the limited time and data available to produce these estimates, they were based on questionable assumptions and extremely limited data.

It must be hoped that Florida's experience with unitary will be a learning one. *TaxWatch* recommends that when reliable revenue estimates are not available, this should be candidly acknowledged. *TaxWatch* further recommends that future Legislatures allow for sufficient deliberation and debate when charting the course of our state. It is only through such deliberation and reason that the best long term interests of Florida taxpayers, as well as the state's immediate revenue needs, are mutually served.

Respectfully,

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SUMMARY OF TAXWATCH FINDINGS AND RECOMMENDATIONS

Findings of this TaxWatch analysis include:

- The Legislature reacted hastily in passing unitary, avoiding the needed deliberation and information for proper lawmaking. The bill was rushed through three committees and passed both chambers within 36 hours. In contrast, when Florida's corporate income tax code was formulated in 1971, there were seven months of extensive public input via statewide hearings. During this time, a conscious decision was made not to use unitary apportionment.
- Estimates overstated unitary's revenue capability. Yet these estimates were promoted as accurate.
- Personal income, used in extrapolating Florida's unitary estimate from California, is not an adequate gauge of corporate activity without adjusting for the makeup of that income. Also, Florida's unitary estimates naively assumed the same level of compliance as California, which has administered some form of unitary taxation for at least 50 years.
- The estimates have been steadily reduced. The original unitary estimate of \$95 million in FY 1984 finally fell to \$40 million, a reduction of 58%. The final estimate of total corporate income tax collections was \$37.5 million less than the estimate without the "propped up" estimate of unitary revenue.
- Growth in total corporate income taxes (with unitary) in FY 1984 was expected to be 40%. In reality, growth was only 11%, or nearly 75% less than forecasted.
- Estimates made by the May 1984 Revenue Estimating Conference members of unitary's 1984 revenue ranged from \$34.0 million to \$64.4 million, a variance of 89%.
- Actual revenue from last year's corporate income tax attributable to unitary (Senate Bill 3C) is unknown. It will not be known with any degree of confidence any earlier than October 1984 when corporate extensions are due and the Department of Revenue can calculate actual payments, with and without unitary and its SB3C provisions.
- Initial revenue losses to Florida under worldwide unitary assessment are quite possible, without gains from foreign source income.
- If unitary taxation is repealed, the need for replacement revenues is only a political necessity, not a financial one. The State of Florida ended FY 1984 with an excess of \$38.6 million over what was officially forecast and appropriated.

TaxWatch recommends that if reliable revenue estimates are not available, this should be candidly acknowledged and considered. It is also recommended that future Legislatures allow sufficient deliberation and public comment to ensure that the long-term public interests, as well as the short term revenue needs of Florida, are served.

THE UNITARY TAX: Florida's Albatross Does it add up?

Introduction

Florida's taxing and spending issues are of utmost importance to the state's economy and public service delivery system. Thus, their careful, deliberate and accurate examination should be demanded by taxpayers and lawmakers alike. In the Summer of 1983, an impatient Legislature, using unreliable revenue estimates, by-passed this vital scrutiny in enacting unitary taxation. This resulted in an unpredictable revenue source that is not producing as expected. Unitary taxation has also harmed, at the very least, the perception of Florida's business environment.

Unitary tax passed
quickly

On July 12, 1983, Senate Bill 3C was adopted, profoundly affecting the way corporations are taxed in Florida. This new law, which applies a worldwide unitary method of accounting for corporate income taxation (called the "unitary tax") has since been the subject of great debate and controversy. Regardless of whether all this furor is warranted, the fact is the bill was hastily drafted, given little consideration and quickly passed. Accompanying this bill were revenue estimates, also hastily produced, which did not reflect the amount of money Florida would actually receive from the new corporate taxing provisions.

Revenue estimates
hastily produced

Passage of the unitary tax is a case of circumvention of the proper legislative procedure - not allowing for sufficient reason, deliberation and public comment - essential elements of effective lawmaking. It is also a case of enacting a new revenue source to produce a specific amount of revenue (in part to fund Florida education) without knowing how much revenue the source would actually bring in.

Moreover, this tax was sold to the Legislature, the media and the public as part of a package of \$233 million worth of General Revenue tax hikes to fund educational improvements. However, the fact is it no more went to education than to fund state employee salary increases, capital improvements and operations, and \$48.9 million worth of GR funded special interest "turkeys"- specific spending items which are of some local benefit to a constituency in a legislator's district but do not serve a statewide purpose or rationale.

What is the Unitary Tax?

Features of the bill:

Worldwide apportionment

Senate Bill 3C brought about major changes to Florida's Corporate Income Tax Code. A worldwide unitary method of apportionment was adopted to determine the taxable income of multi-state and multinational corporations that do business in Florida. Under this method, all related operations of a given business entity are treated as a single unit - a Unitary Business Group (UBG). Florida now taxes a proportion of the UBG's total worldwide income equal to the proportion of the group's total property, payroll and sales in Florida.

The new law also:

Taxing foreign source income

- dropped the exclusion of foreign source income from taxation. Thus, Florida corporations must now include sales to foreign countries in the calculation of their income tax.

Disallows apportionment of non-business income

- disallows the apportionment of non-business income. This income arises from non-unitary aspects of a business such as dividends, interest, rents, royalties, etc. Previously, Florida allowed non-business income earned in this state to be apportioned to other states, but could not allow such income, earned elsewhere, to be apportioned to Florida. All non-business income earned in this state is now fully allocated to Florida.

"Throwback rule"

- adopted a "throwback rule". Under this provision, a sale is considered made in (or "thrown back" to) Florida if a product is sold or delivered to: 1) a purchaser in Florida, regardless of its ultimate destination; 2) the Federal Government; or 3) if the taxpayer is not subject to an income tax in the state to which the sale would have previously been assigned.

Retroactive

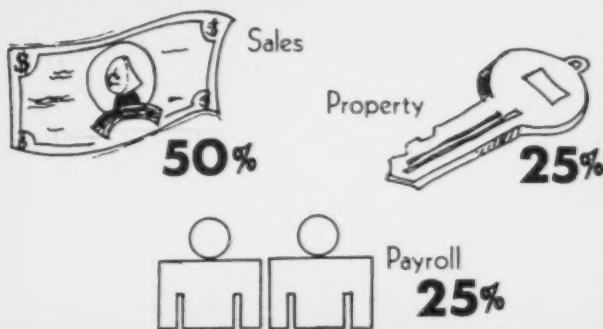
- is retroactive. All corporations with a fiscal year beginning on or after September 1, 1982 were fully and immediately subject to the tax.

Possibly the most severe application

Florida's unitary law is possibly the most severe and far reaching application of the unitary concept of taxation. Although similar to California's, Florida's law contains a major distinction. While other states give an equal weight of one-third to each component of the apportionment factor (payroll, property and sales), Florida assigns 50% to sales and 25% to each of the other two. This double weighting of the sales factor increases the severity of the "throwback rule".

Although not actually an added tax, but a mandated method of accounting, unitary, as well as the other corporate tax changes contained in Senate Bill 3C, will be referred to in this report as the unitary tax.

How the Corporate Income Tax is Apportioned



GRAPHIC: Florida TaxWatch Inc.

Legislature Hastily Passes New Revenue Source

The unitary tax surfaced in the wake of the 1983 Legislative Session and two succeeding special sessions. During this time, the Legislature did not appropriate all the money the Governor wanted for funding his education package and recommended state budget. The two chambers could not agree on revenue needs, and attempts to hike existing taxes were vigorously opposed. Time ran out.

Consequently, the Governor called Special Session "C" on July 7. This came just ten days after the Container Corporation of America vs. Franchise Tax Board decision in which the U. S. Supreme Court upheld California's unitary method of taxing foreign subsidiaries of a California parent company. This was, as one Florida legislator put it, "like finding money on the street and we grabbed it." After searching in vain during the previous session for a source of new money both chambers could

Container decision
offered a revenue
opportunity

Little public debate

agree on, this new revenue opportunity arose. The Legislature quickly seized the opportunity. The bill was drafted by legislative staff over the weekend. It was rushed through, with only brief discussion, at three committee meetings within a twenty-four hour period. In fact, affected parties and business representatives did not have an opportunity to review this extremely complicated bill until these meetings. Twelve hours later it had passed both chambers. There was little, if any, opportunity for public debate or commentary. Certainly the deliberation usually afforded and due a major piece of legislation was missing.

By contrast, when Florida's corporate income tax code was formulated in 1971, there were seven months of extensive public input and debate via hearings throughout the state. In 1983, this major revision of the code received only five hours of testimony. With little background or knowledge of the unitary method, legislative debate centered not so much on its merits and implications, but on the "need to get something done". As a key legislator remarked on the floor of the Senate, "If we don't vote for this, we'll be up here day after day, flopping around, looking silly."

THE ESTIMATES: Quickly Done, Accuracy Dubious

Revenue estimates were needed to give the hurriedly drafted bill some credence. These were hastily created without the historical or other relevant data with which to make valid and meaningful projections. Forecasting the revenue from unitary taxation is a most difficult undertaking. But due to time constraints imposed by the special session, estimates were required faster than estimators would have liked. Still, these numbers, which members of the State Revenue Estimating Conference have described as "very, very soft estimates", were promoted by state officials as accurate.

Florida's estimate extrapolated from California while major adjustments needed

Estimates of the revenue unitary taxation would bring to Florida were set at \$95 million for FY 1984 and \$115 million for FY 1985. With Special Session "C" imminent, these estimates had to be derived quickly, without time for the normal research, analysis and give and take among estimators that produces the state's best estimates. Having no historical quantitative data to work with, the FY 1984 estimate was extrapolated from California's forecasted unitary revenue of \$500 million. Florida estimators chose to use the size of the State's personal income, relative to California's, to adjust the \$500 million downward to reach an estimate of unitary's projected revenues.

This reduced the \$500 million figure by almost two-thirds, since Florida's total state personal income is 37% of California's. Then, considering Florida's corporate income tax rate of 5% - compared to 9.6% in California - Florida's revenue estimators came up with a figure just under \$100 million. This

number was briefly discussed by representatives and support staff of Florida's Consensus Revenue Estimating Conference (House and Senate Finance and Tax Committees, the Joint Legislative Management Committee, the Department of Revenue and the Governor's Office of Planning & Budgeting) and - rather subjectively - \$95 million became Florida's official unitary tax revenue estimate for FY 1984.

Estimate set at
\$95 million

The estimate of \$115 million for FY 1985 was calculated by increasing \$95 million by projected growth in the corporate revenue base.

Two questions arise from this method of estimation: 1) Is California's estimate reliable?; and 2) Is personal income an appropriate extrapolation factor when Florida's economy, transfer payments and industrial base are so vastly different from that of California?

In response to the first question, revenue estimators concede it is virtually impossible to arrive at a "hard and fast" estimate of unitary revenue. Only limited faith can be placed in any such estimate. In fact, even the Controller of California states that the \$500 million estimate is correct - plus or minus 40%. It must be noted that California has had 50 years of actual historical data on which to base such estimates. When the basis for an estimate is in doubt, the estimate itself must certainly be questioned.

Poor reliability in
California's estimate

Further, differences in corporate makeup between Florida and California lessen the reliability of using California's experience as a base. Then there are differences in the law itself, including Florida's double weighting of sales, that further affect the revenue capabilities of the two states' laws.

Personal income, without proper major adjustments, does not seem an adequate gauge of comparison of corporate activity between these two states. Comparing manufacturing earnings - the largest source of foreign taxable income - with total personal income illustrates this. California's manufacturing earnings are double the size of Florida's as a proportion of each state's total personal income. Moreover, transfer payments (social security, pension, etc.), again using personal income as a measure, are 31% larger in Florida than California. These factors suggest an overestimation of Florida's corporate income under such a method of calculation.

Personal income not
an adequate gauge of
corporate activity

Feds Try to Estimate Unitary

A few months after Florida's original estimates were made, the Worldwide Unitary Taxation Working Group, headed by U. S. Treasury Secretary Donald T. Regan and including representatives from Florida, attempted to assess the economic impact of worldwide unitary taxation nationally.

Using Internal Revenue Service data from 3,000 U. S. parent companies and 33,000 controlled foreign subsidiaries, this

national task force computed the estimated national corporate tax take increase under unitary taxation. Assuming the effect on Florida's corporate tax revenues would be identical to the rest of the nation's (which is, at best, highly unlikely), it was estimated that the unitary tax would raise \$125 million for the state in FY 1984. This figure assumes full compliance, meaning the number is a forecast of tax liability - not revenue collections.

Florida's revenue estimators suggest that this, at least in part, substantiated their original estimate because the \$95 million figure assumes some non-compliance. However, the level of non-compliance was assumed to be the same as in California. Actually, with many years of experience in administering the law, California's compliance should be much greater than Florida's. This, along with the assumption that the liability of Florida corporations would be affected to exactly the same degree as the nation as a whole, casts substantial doubt on the validity of the two Florida estimates, since both use assumptions which are faulty.

Corporate Tax Revenue Lags Far Behind Estimate

Corporate income did not produce as expected in FY 1984

As FY 1984 wore on, it became clear that Florida's corporate income tax was not going to produce as expected. Critics said the unitary tax was not the revenue producer it was touted to be. Others claimed unitary was propping up a badly sagging corporate tax base. In truth, no one can presently ascertain how much of the collected corporate tax is attributable to the changes contained in SB3C. Whatever the exact cause, total corporate collections are not coming in as anticipated.

In May 1983, Florida's pre-unitary corporate income tax was forecasted to reap \$497.5 million in FY 1984. When unitary was passed in July, the estimated additional \$95 million brought the total corporate income tax projection to \$592.5 million.

The first five months of FY 1984 saw corporate tax collections come in \$30.4 million below estimate, led by a \$22.9 million underage in October 1983, a big collection month.

Unitary estimate first reduced to \$78.6 million

In December 1983, the Revenue Estimating Conference (REC) met and, in light of those shortfalls, reduced the corporate estimate \$34.5 million to \$558.0 million. The unitary portion was scaled down to \$78.6 million. Thirteen million dollars of this unitary reduction was expected to lag into FY 1985, which would have increased the original estimate to \$128 million. Despite this forecasted non-recurring gain, 1985's unitary portion was actually reduced to \$107.4 million.

Following December 1983, when corporate receipts came in \$.9 million over estimate, the slide resumed. The next four months all had shortfalls, ranging from 88.4% to 55.9% of the estimate, totaling \$58.2 million. Receipts in April, generally the largest collection month, fell \$30.7 million short of anticipated revenue.

Another reduction followed. The May 1984 REC slashed \$98 million from the total corporate revenue estimate made in December 1983, lowering it to \$460.0 million. This new figure was \$37.5 million less than the pre-unitary estimate. The unitary portion was reduced to \$40 million for FY 1984, less than half its original estimate. The FY 1985 unitary estimate was similarly reduced to \$76.6 million, \$61.0 million recurring and \$15.6 million in non-recurring receipts (taxes which are thought to come from the prior year's activities).

How Much Has Unitary Actually Raised?

After a year of collecting corporate income tax revenue through the unitary method, the question arises: How much has Florida actually made from unitary? No one knows with any reasonable degree of confidence. No evidence has been presented to date to combat the suspicion that worldwide unitary assessment may in fact be a direct money loser, let alone not contributing to the original estimate of \$95 million for Senate Bill 3C.

FY 1984 saw Florida recovering from a recession similar to the economic rebound that occurred in FY 1978. In that year, rejuvenated corporate profits led to income tax collections increasing 32%. Similarly, healthy collection growth - although probably not as substantial - could have been expected in FY 1984. Indeed, estimators forecast corporate growth of over 17% for FY 1984 before enacting unitary taxation. Add to that the original projection of unitary's contribution and 40% growth was anticipated. Actual collections in FY 1984, however, increased only 11% over FY 1983. Meaning: Florida's total corporate collections growth rate (including unitary) was actually almost 75% less than what was officially forecast.

In contrast, Florida's sales tax collection growth of 18.7% in FY 1984 slightly surpassed the 17.6% growth that occurred in the recovery of FY 1978. Examining another economic gauge - Florida's unemployment rate - again points to the similarity of the economic rebounds of 1978 and 1984. 1977 had an average unemployment rate of 8.2%, compared with the April 1983 rate of 8.4%. As the economy improved in 1978 and 1984, the unemployment rate dropped to 6.6% and 5.7% (April), respectively.

Although economic circumstances in 1978 and 1984 were similar, corporate income tax collection growth - even with projected added revenue - was two thirds less in FY 1984 than FY 1978. This provides additional evidence that worldwide unitary assessment may be a money loser, at least initially, in terms of actual corporate income tax receipts and may be depressing overall corporate tax collections. Indeed, without the provision for taxing foreign source income, it is likely that Senate Bill 3C would have resulted in an actual revenue loss in FY 1984. In fact, although the existence of foreign source taxation should preclude such a loss, there is no assurance that there is adequate compliance and remittance to do so.

Unitary estimate finally reduced to \$40 million

FY 1985 unitary "replacement" set at \$76.6 million - \$61.0 million recurring, \$15.6 million non-recurring

Unitary actual revenue unknown

40% growth in corporate tax revenue was expected, actual growth rate was 11% or nearly 75% less in reality

Reduced Tax Liability Possible Under Unitary

Reduction in tax liability possible under unitary

It is possible for a corporation to reduce its tax liability under unitary. If a corporation's foreign operations are less profitable than its domestic counterparts, worldwide apportionment would allow for decreased taxes. As the national, and to an even greater extent Florida's, economy outperforms the economies of most foreign countries, such instances are likely. Corporations which save money under the unitary method are more likely to pay their taxes on time. Conversely, corporations with increased liabilities might not be so expedient in their remittance.

Initial losses under unitary assessment likely

Add to this the confusion on the part of taxpayers, as well as the difficulty of ensuring compliance of this new tax, and initial losses under unitary assessment become more understandable. California's Controller stated during legislative hearings that this could indeed happen.

Consider the case of Minnesota, which enacted unitary taxation expecting to produce \$63 million during the 1981-83 biennium. When no revenue from unitary was received in 1982 and again in 1983, the estimates were reduced and pushed into succeeding years. Minnesota has yet to receive any revenue from unitary and the official estimates through 1985 have been reduced to zero. Minnesota's Governor has called for its repeal.

Actual Unitary Revenue Unknown

Determining the amount of unitary revenue from last year will take time

Whether Florida's unitary taxation has resulted in a lot of money, little money or even a loss of money, the bottom line is: No one knows. There will not even be a basis to determine unitary's true revenue capabilities until October 1984 due to Florida's collection schedule, and that will only be a start.

Most Florida corporations affected by unitary taxation pay their annual estimated tax in four installments. These are due on the first day of: the fifth month of the taxable year; the seventh month; the tenth month; and the following taxable year. A return and reconciliation are due on the first day of the fourth month of the following year. Since Florida largely piggybacks the federal corporate tax, the state allows the federal extension of up to six months. Because most corporations are on a calendar taxable year, most returns are due in April and the extension ends in October. Consequently, by October 1, 1984 all returns for fiscal year 1983 are required to be remitted to the Florida Department of Revenue.

Revenue Department has the massive task of auditing

From there, discovering how much the unitary tax raised will be a lengthy process. The tabulation of all data will take some time, then each corporation's tax liability without the unitary method of accounting must be figured. In addition, the Department of Revenue will have the massive task of auditing to ensure compliance.

Although the amount of revenue attributable to the worldwide unitary provision of Senate Bill 3C will be difficult to compute, the money generated by taxing foreign source income will be much easier to identify. Revenue from this provision of the law can be more readily quantified and captured since many of these corporations have historically reported the amount of their foreign source exclusion.

Why the Estimates were Reduced

If the unitary portion of the state's corporate tax revenues is unknown, why were the estimates reduced? One reason is the Revenue Estimating Conference contends it misjudged Florida's rebound from the recession, overestimating corporate income. When the money didn't come in, the base estimate, along with the unitary portion, was reduced.

Secondly, some state economists suggest that non-compliance is greater than anticipated. However, they could not and did not specify what level of non-compliance should, or is likely to, exist. With the possibility of repeal by the 1984 Legislature, many corporations may have adopted a "wait and see" attitude, inducing some delays.

Thirdly, there are concerns of the law's ambiguity, perhaps as a result of the haste in which it was drafted. No one, including state officials, is completely certain as to what constitutes a unitary business group. Florida will rely on other states' records to help determine which companies fall within the definition of unitary. Litigation over this point is certain and likely to be extensive.

Some "loopholes" that exist in the unitary tax legislation (SB3C) have added to the law's confusion and lack of clarity. Revenue estimators assert that the following loopholes have had a negative, although probably small, impact on collections.

- The Domestic International Sales Corporations (DISCs) loophole. DISCs have since been eliminated by the federal government. DISC revenues were treated as an intragroup dividend and not subject to taxation under unitary. Some state officials were concerned that more and more corporations would set up DISCs to lower their tax liability. However, this has been negligible for Florida and is now eliminated nationally.
- The "Arthur Young loophole", named after the accounting firm that revealed it. In 1981, the Florida Legislature, concerned that the accelerated depreciation clause of the national Economic Recovery Tax Act would cost the state revenue, began allowing companies the option of computing their taxes based on either the 1980 or 1981 federal tax code. The 1980 Internal Revenue Code did not include the depreciation clause and, of course, did not include unitary taxation. By electing the

Some say non-compliance greater than anticipated

Portions of law ambiguous

Possible loopholes exist

1980 code, Arthur Young says a few select companies can avoid the unitary method of taxation.

- A loophole involving the bill's definition of "taxpayer". This word, contained in the definition of Unitary Business Group, might be used to attempt excluding any corporation not jurisdictionally present in Florida from unitary taxation.

Some corporations
may be holding back
payment.

Lastly, as discussed earlier, corporations with a reduced liability under unitary have surely already reduced their tax payments. Conversely, corporations with large increased liabilities may be holding back payments - hoping for protection from repeal or the law's ambiguity.

These and other factors led the State Revenue Estimating Conference to reduce the estimates of unitary tax revenue. Again, without concrete quantitative data, verifiable estimates are impossible. Illustrating this are the differences in the estimates provided by the various members of the May 1984 REC. These ranged from \$34.0 million to \$64.4 million (a difference of 89%) in FY 1984, and from \$56.9 million to \$85.0 million (a difference of 49%) in FY 1985.

By contrast, the other taxation measure contained in SB3C - alcoholic beverage tax hikes - produced very close to projections. This new revenue resulted from an increase to an existing tax, thus lending itself well to reliable forecasting. It was originally estimated to produce \$71.4 million in additional beverage taxes in FY 1984, pushing total collections to \$414.4 million. Actual collections came in at \$412.0 million, virtually on target with a very negligible error of 0.6%.

Total GR for 1984
exceeded estimate
by \$38.6 million

Although the first full year of post unitary corporate income tax revenue fell short of the original projection by \$121.4 million (20.5%), the estimators scored a near bullseye on the state's total General Revenue (GR). Actual total GR for FY 1984 came in only \$38.6 million above the May 1983 estimate, an error of less than one percent. Corporate income is the second largest GR source. The big lag in corporate was more than offset by unexpectedly high sales tax collections, the largest GR source.

Florida's corporate income tax has historically proven to be one of the toughest General Revenue sources to forecast. The complications of the unitary method make it even harder, if not impossible. Governor Graham's Unitary Tax Study Commission stated in its March 1984 report: "In fact, reliable estimates of the revenue impacts of the individual components (of the unitary tax bill) were not readily available during the life of the Commission, and are probably not attainable at all" (emphasis added).

Unitary Stirs Debate Among States

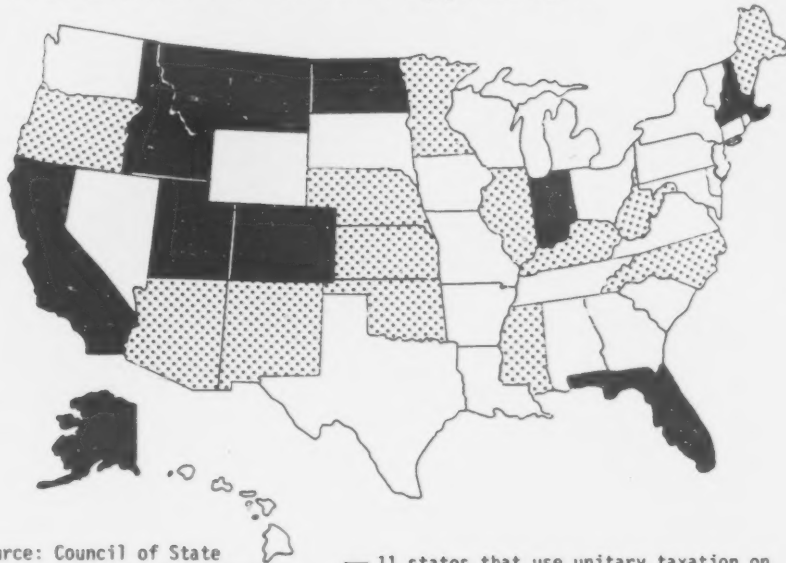
There are currently 24 states with some form of unitary taxation. Thirteen of them have provisions for a "water's edge" or domestic unitary, approach. Under water's edge, the overseas profits of a corporation are not considered in the apportionment of income, only profits earned in the United States. The other eleven, including Florida, use the worldwide unitary approach. According to the Council of State Chambers of Commerce, of the 13 states using domestic unitary, only five normally require the method. The others use it only on a selective basis.

24 states have
some form of
unitary

In March 1981, the Illinois Supreme Court ruled that corporations in the state may use worldwide apportionment, even though Illinois was not using unitary taxation. In July 1981, the

Unitary Tax States

International vs. Domestic Applications



Source: Council of State
Chambers of Commerce
and Florida TaxWatch
Inc. (Sept. 1984)

- 11 states that use unitary taxation on firms' US and international operations
- 13 states that use unitary taxation on firms' US operations only

Illinois Department of Revenue passed emergency regulations requiring worldwide unitary taxation. Illinois suddenly found itself faced with refunds - applied for by corporations with decreased tax liabilities - totaling nearly \$200 million.

Numerous states re-
treating from
unitary

The 1982 legislature easily passed a bill abolishing unitary taxation in Illinois. However, the Governor vetoed the bill and a "water's edge" compromise was reached.

The Governor of Minnesota, in light of his state's failure to produce revenue from unitary taxation, has called for its repeal. Other states, citing discouraged business investment, are either fully or partially repealing their unitary methods. New York repealed its worldwide unitary tax on June 26, 1983, one day before the Container decision. Oregon repealed the worldwide portion of unitary on July 30, 1984. New Mexico retreated from worldwide unitary in 1983 and the Indiana legislature has reached a bi-partisan agreement to repeal it during the next session. Neither New Mexico nor Indiana enforced the method, using it only in rare cases where corporations were thought to be grossly shielding income from taxation. Officials from both states have indicated that the fact the law was on the books was disincentive enough to keep companies from locating or expanding in their states.

Problems Should Have Been Anticipated

During the last year of Florida's unitary experience, many complaints have sounded over its evils. These problems, whether real or perceived, should have been anticipated and carefully considered before passage of SB3C. Adequate time for proper notice, dissemination of information for debate and examination of the proposed law would have allowed for this.

Widespread claims of
economic harm from
within and outside
Florida

In addition to complaints about its revenue capability, there are widespread claims, both within and outside the state, that the unitary tax and all its provisions are destroying Florida's attractive business climate. Detractors say it will retard economic growth, costing jobs. There is the well publicized cancellation of IBM's expansion plans in Boca Raton, as well as IBM's sale of a 2,000 acre parcel in Alachua County. Both actions were attributed to the existence of the unitary method of taxation in Florida.

Trading partners
call for repeal

Numerous complaints have also been voiced by foreign trade partners. Japan's Federation of Economic Organizations has stated that Japanese firms will not locate in states with worldwide unitary taxation. The European Economic Community and the national governments of England, Canada, Australia and Switzerland have called for repeal. This also included threats of reprisal taxes against U. S. corporations. These dissenters comprise 84% of total direct foreign investment in the U.S.

Regardless of the actual extent of unitary's adverse effect on Florida's economy, the business and financial community,

within and outside Florida, concludes it is substantial. TaxWatch conducted a survey of Fortune 500 and Florida based companies after enactment of the unitary tax. The 118 respondents overwhelmingly had very negative perceptions of its effect on their businesses and Florida's business climate. 93% of the Fortune 500 respondents indicated a negative effect on their future decisions to locate, relocate or expand their facilities or operations in Florida. Over half of the Florida respondents saw a negative effect on relocation or expansion in the state. Only 2% of total respondents stated the new law would not have a negative impact on Florida's image as the state with the top business climate. 81% and 92% of Fortune 500 and Florida respondents, respectively, ranked Florida's climate in the upper quartile prior to the new law. Conversely, 78% and 51%, respectively, ranked Florida below average after unitary's passage.

TaxWatch Survey:
Unitary hurts
Florida's business
climate

(Complete results of the survey, including industry breakdowns, are available from Florida TaxWatch, Inc.)

Besides the negative economic view of the unitary tax, opponents cite its complexity as a problem. They argue it flies in the face of two of the fundamental guidelines written directly into the Florida Corporate Income Tax Code adopted in 1971: ease of compliance by business and ease of administration by the Department of Revenue.

Some businesses assert that the new accounting method is cumbersome. Another problem with worldwide assessment is the differences in accounting practices among foreign countries. This not only complicates matters for the taxpayer - but also for those auditing and enforcing unitary taxation.

**Unitary presents
accounting and au-
diting problems**

Change in Law Grows More Likely

All this backlash has had an effect. Even the Governor, unitary's staunchest supporter, has softened his stance, advocated a "water's edge" approach and agreed to repeal the law if replaced directly by business tax increase(s). Recently, the Senate President-designate said he would support calling a special session to repeal the unitary tax and support a one half percentage point increase in the corporate tax rate as a replacement (a 10% tax rate hike). In Washington, after the Regan Commission completed its work, the Treasury Secretary recommended that President Reagan consider national legislation to eliminate unitary taxation if individual states do not back away from worldwide unitary assessment by July 1985.

**Florida consider-
ing repeal**

As talk of full or partial repeal continues, the importance of Florida's revenue estimates grows. With the Governor's insistence that any repeal measure provide a source of replacement funds, the official \$76.6 million unitary revenue projection for FY 1985 becomes even more crucial. Will the state actually lose that much under repeal? Could it be more, or less? Does anyone really know? These questions should be answered before replacement funds are sought.

**Actual revenue must
be determined before
replacement funds
are sought**

The actual need for replacement revenue is only a political necessity since the Governor and House and Senate presiding officers will not repeal unitary without new replacement taxes from business. Additional taxes are not, in and of themselves, necessary. The state's net General Revenue collections for FY 1984 exceeded the May 1983 estimate by \$38.6 million.

Replacement is a political necessity, not a financial need

The replacement of a tax source that provides an unknown amount of money, if any, must be questioned. It must be remembered that although corporate tax collections came in far below estimate in FY 1984, total General Revenue exceeded projections. Consequently, in the event of full or partial repeal of the unitary tax - any replacement funds sought won't be to make up for lost revenue - but to pay for a mistake made by public officials.

Conclusion: Lessons to be Learned

The Florida Legislature, acting in haste, created an albatross for the state with the unitary tax. It tapped a revenue source that is, at best, unpredictable and most costly and burdensome to administer. The revenue estimates for the law - the dollar figures that gave the bill its appeal - were not reflective of its actual revenue production. Since Florida's budgeting is based on revenue estimates, reliable forecasts are essential.

Lack of reliable estimates must be acknowledged

TaxWatch recommends that if such estimates are not available, this should be acknowledged in candor and considered. To do otherwise before legislators writing and voting on new tax laws, the media and people of Florida is a disservice to the taxpayers of Florida, our industry, economy and the integrity/credibility of the State Revenue Estimating Conference itself.

The unitary tax is an example of what can happen when the Legislature circumvents its normal process by not allowing for the proper public input and debate necessary to warn of potential problems. Hopefully, this will be viewed as a learning experience for which the Legislature is now wiser.

Legislature must allow sufficient deliberation for proper tax policies

TaxWatch recommends that future Legislatures provide for the needed deliberation to ensure that the long-term public interests, as well as Florida's short-term revenue needs, are served.

Senator HAWKINS. Thank you.
Ms. Lackey.

**STATEMENT OF MARY LOU LACKEY, REGIONAL DIRECTOR OF
STATE RELATIONS, MOTOROLA INC., BOYNTON BEACH, FL**

Ms. LACKEY. Good morning, Senator Hawkins, and thank you. I appreciate the opportunity to be here today representing Motorola Inc.

Motorola is one of the world's leading manufacturers of electronics, with operations in 110 countries around the world and two key divisions headquartered in Florida. Our company has obviously been dramatically impacted by Florida's adoption of unitary taxation, and we have been very actively involved in the efforts to obtain repeal of that taxation.

The Florida situation provides an excellent case study on unitary taxation. The passage was very recent. It has been extensively debated and analyzed, and has received extensive press coverage both in the United States and around the world. In addition, the adoption of unitary was a dramatic change—legislative change—from the prior Tax Code, unlike the situation in other unitary States, where unitary has evolved over a period of many years through administrative rulings or court rulings. So, therefore, the issues are much more readily apparent in Florida than perhaps they are in some other States.

The reasons for the opposition to unitary are varied and are numerous, and we have already heard many of them today. My written testimony addresses them in greater detail, but just to summarize and to give an idea of the range of issues that are involved, let me recap some of them.

Very real double taxation exists with the unitary method. Worldwide unitary taxation combines the pretax income of the members of the group, with no deduction and no regard for taxes that have already been paid in foreign countries, often at very high tax rates.

Administrative costs and burdens have been mentioned by numerous speakers. They are very high and oftentimes exceed the costs of the tax itself. They are the result of language problems, currency problems, currency fluctuation problems, and other factors.

It should also be pointed out that, because each State's unitary taxation provisions are so dramatically different, a different return must be prepared in each State. It is not simply a matter of preparing a single unitary return and submitting it in the various States which use the unitary method.

In some instances, there are legal barriers by foreign governments to the provision of the data which the States are asking for. Even if there is not an actual legal barrier against the provision of such data, there certainly is a resistance on the part of some foreign corporations toward providing information on their worldwide activities to a subsidiary that may be only a very small portion of their total operations.

These increased administrative costs—and this is an issue which has been mentioned much today—are also borne by the States. Where, prior to Florida's adoption of unitary taxation, the State's

Tax Code piggy-backed the Federal Tax Code, there was a fairly minimal audit staff required. Under unitary taxation, not only is there a need for increased staff, but also there must be a multinational complexity given to that audit staff.

The opposition of foreign governments is obviously of tremendous concern to this committee, and has been touched on by other speakers. The business community is also concerned, as the retaliatory measures could come in any of a number of different ways.

One way might be reduced trade opportunities, not only for the multinational corporations, but for the business community as a whole. You have heard about the threats of the British to reduce tax rebates which are now given to U.S. corporations that operate in Great Britain. The very corporations that are already suffering under unitary would, therefore, suffer even more. The attempt is to retaliate against the unitary States; the effect would be to hurt the multinational corporations.

There is certainly a very real possibility that other foreign countries may adopt their own form of unitary taxation, again with the intent of going back against the unitary States, but with the real impact going back on the business community.

In addition to these factors, which are fairly standard in all States which have addressed unitary or which have adopted unitary, there are also specific implications in Florida which have made the controversy even more intense.

Mr. Shebel discussed the means of adoption. One highranking Florida official referred to it as the "Raid on Entebbe" approach. I am sorry to say that that was a very accurate description of the means of passage, and this created a tremendous amount of resentment on the part of the business community.

There is also a tremendous inequity in the impact. Florida adopted unitary taxation as a means of implementing educational improvements which would benefit the entire State, and certainly the entire business community. However, it has been estimated that less than one-half of 1 percent of Florida's corporations have shouldered the entire burden of the cost of these educational improvements.

Another issue is the retroactivity of Florida's bill. It was passed in mid-July 1983, retroactive to September 1, 1982. Within 6 weeks of passage, the law was in full effect. Rules had not been promulgated, and definitions and interpretations were not yet available.

Another factor was that there was no evidence of abuse of the Tax Code on the part of Florida corporations. This is an explanation which is often used by State administrators for the need for unitary taxation. However, in Florida, State officials admitted and testified that there was no evidence of abuse, and they had not attempted to use existing audit tools that were available to check for such abuse.

The impact on the State's economic development has been well documented. Current reports show that foreign investment in Florida is way down substantially. The impact—and I am sure Dean Lanzillotti will touch on this in his testimony—on the State's economic development activities has been tremendous.

All of these additional factors have added fuel to the fires of opposition in Florida. But it is the basic inherent flaws in unitary which form the real basis for opposition.

As you have heard, Florida's legislative leaders appear committed to the repeal of unitary. We sincerely hope that they will, and that other States will follow suit. This issue is of great importance, for we cannot allow our international trade relations to be jeopardized by the actions of the individual States.

Thank you very much.

[Ms. Lackey's prepared statement follows:]



MOTOROLA INC.

STATEMENT OF
MARY LOU LACKEY
REGIONAL DIRECTOR, STATE RELATIONS
PORTABLE PRODUCTS AND PAGING DIVISIONS
MOTOROLA INC.

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON FOREIGN RELATIONS

SEPTEMBER 20, 1984
WASHINGTON, D.C.

The State of Florida provides an excellent case study of the impact associated with the worldwide unitary method of apportionment. This method of taxation was adopted only recently, and involved a total change in the State's tax policy, unlike the situation in other states, where the use of worldwide unitary has evolved over a period of many years. The issue has been debated and analyzed thoroughly, and Florida's activities on the subject have received extensive media coverage throughout the United States and around the world.

Many of you may be familiar with the circumstances leading to Florida's adoption of this method of corporate income taxation. The 1983 Legislative Session was a frustrating one; improvements to the State's public education system were identified as a top priority by both the business community and by Legislative leaders. However, during the regular and two subsequent special sessions, there were major disagreements as to the appropriate nature for these improvements, and the two chambers of the Florida Legislature and the business community were unable to reach consensus on how these educational improvements should be funded.

The Legislature finally passed a "continuation" budget, containing no major increases in educational funding. Governor Graham vetoed this portion of the State budget, leaving no State appropriations for the State's schools. As the beginning of the school year approached, it was critical that a solution be found.

When the United States Supreme Court ruled on the Container case on June 27, 1983 (the case which upheld the use of worldwide unitary taxation in California), Florida immediately seized upon it as a mechanism to generate revenue. As one Legislative leader described it, "It was like finding money on the street, and we grabbed it." Less than two weeks after the Court ruled on Container, Florida convened a hastily called special session and passed sweeping changes in the State's corporate income tax code. There was little opportunity for input from the business community, and many Legislators openly admit that they had no understanding of the impact and effect of the complex legislation which they passed.

The opposition from the business community was immediate and forceful, and has continued to intensify in the 14 months since initial passage. That opposition has come, not only from the directly affected multinational companies, but also from all elements of the business community. Companies not directly affected by the taxation changes still recognize that their economic well-being is largely dependent upon the overall health of the State's economy as a whole, and that, through multiplier effects, virtually all aspects of the business community will suffer by Florida's adoption of worldwide unitary taxation. Florida's business community has been united in its push for total repeal of unitary.

Motorola Inc. is one of the world's leading manufacturers of electronic equipment, systems and components, produced for both United States and international markets. Two key divisions of the company, the Portable Products Division and the Paging Division, are headquartered in Florida. With over 4000 employees in the State, Motorola is one of the ten largest manufacturing employers in Florida.

Motorola has strongly supported the need for improvements in Florida's educational systems, and has been supportive of increases in taxation to fund such improvements. However, as a multinational corporation with major operations in Florida, Motorola is severely impacted by this adoption of unitary taxation. Correspondingly, the company has been one of the most active in the ongoing efforts to obtain repeal of these damaging and inequitable tax provisions.

Many of the grounds for opposition to Florida's unitary taxation are the same as those in any state which considers or utilizes unitary. The objections are many and varied, but some of the most frequently mentioned and most important are summarized here:

Double Taxation - The use of unitary taxation leads to very real double taxation of corporate profits. Other countries and other non-unitary states apply their tax rate to the full profits of corporations operating within their jurisdictions. Florida and other unitary states, on the other hand, combine the pretax income of corporations which they deem to be unitary in nature, and apportion the profits of

this unitary group for taxation -- with no deduction for corporate income taxes, often at very high rates, which have already been paid on this income in other countries. Documented examples of dramatic double taxation -- sometimes more than half of a corporation's total profits -- have been presented in Florida and in other states. The Supreme Court acknowledged in the Container case that double taxation does exist with unitary taxation.

Administrative Costs and Burdens - The costs of compliance with unitary taxation provisions are enormous, and often exceed the dollar amount of the actual tax paid. It is important to note that requirements and definitions vary widely between the unitary states, and separate, different returns must be prepared for each. These differences relate not only to what is taxed by the state, but also the very basic definition of what corporations are included in a unitary group. Furthermore, the information required for these state returns is far more extensive than the consolidation of income required for Federal income tax returns or for the development of annual reports and associated financial reports required by the Federal government.

The compilation of the data required by unitary states is compounded when the unitary group includes corporations in foreign countries. For example, Motorola's 80,000 employees are located in major facilities and sales offices in 110 countries around the world. Language and cultural differences abound, and currencies differ, and are continuously affected by fluctuation exchange rates. Corporations within the same unitary groups may operate on different fiscal years, which must be changed to that of the corporation within the unitary state.

One of the most burdensome requirements is that all of the financial statements of the entire unitary group must be converted to United States accounting principles, which often differ from the accounting requirements of other countries. All of these burdensome requirements are in full effect -- even if the operations within the unitary state represent only a small portion of the unitary group's total worldwide

operations, or if the in-state operations have no functional relationship with the other members of the group.

In the case of unitary group members in foreign countries, there are sometimes legal prohibitions against the provision of the data required by the unitary state, particularly where corporations may have joint ventures with governmental agencies. Even where legal barriers do not exist, there is often a strong resistance on the part of foreign corporations -- especially foreign parent corporations -- to provide information on operations which have no bearing on the operations within the unitary state. There are also no adequate safeguards against disclosure of such information.

Administrative costs and burdens associated with unitary returns are also placed on the unitary state. The same language, cultural and currency differences make audits extremely difficult, and major additional costs for increased staff and resources are required to audit unitary returns.

Flaws in the Basic Concept of Worldwide Unitary Taxation

The entire concept of unitary taxation is flawed -- particularly when applied on a worldwide basis. Unitary apportionment divides the combined profits of a unitary business group among jurisdictions based on a series of factors -- usually the amount of property, payroll and sales which the unitary group has in the state as a percentage of the total worldwide property, payroll and sales. This mechanism assumes that these factors are constant worldwide, and that each dollar spent on property and payroll everywhere in the world will generate the same proportional amount of income. This is, of course, absolutely untrue, and ignores the economic realities of worldwide operations.

Multinational corporations establish operations outside their home countries for a variety of reasons. Sometimes resource availability dictates where operations must be located. In many other instances, it is necessary to establish foreign operations in order to gain access to those markets, due to government policies or customer preferences. Although there may be lower capital or labor costs in some offshore locations, there are also often increased domestic costs as a

result of distance, language, cultural and other barriers. Inflation rates are often substantially higher in foreign countries, and companies also frequently face substantially increased risk in foreign countries, particularly from a political standpoint.

When making an investment decision, these risks and benefits are considered. If, for example, a significant political risk exists, a firm such as Motorola expects a higher profit margin to result, and the profits generated by these foreign corporations should not be apportioned to unitary states. Conversely, if an offshore corporation is not profitable, the United States profits should not be apportioned to the foreign corporation, thereby reducing the group's state tax liability.

More importantly, major corporations in all sectors -- but particularly those in high technology businesses, such as Motorola -- deal in a global environment. Products are highly specialized, and the firm is competing with other major multinational firms, not with other local suppliers. The prices for products are determined by highly competitive worldwide market forces. Therefore, increased business costs which are locally generated and which do not affect competitors in a similar fashion cannot be passed on in a competitive sales price, but must be absorbed by the company. Worldwide competitors -- in Japan, Europe and elsewhere -- will use the best resources available throughout the world to posture themselves competitively. American companies must not be penalized for doing the same, which the application of unitary taxation effectively does.

Artificial Shifting of Income - Another flaw in the concept of unitary taxation involves the states' artificial shifting of profits from one jurisdiction to another. Proponents of unitary often claim that unitary is necessary to prevent companies from shifting income to avoid taxation. As discussed earlier, there are many legitimate reasons why companies must have offshore operations. However, even in cases where there is no indication that corporate structure has been used in an attempt to avoid taxation, the states' use of unitary involves artificial shifting of income in order for

the state to gain tax revenues. This shifting destroys the relationship between the generation of profits and the corresponding generation of taxation, and is no more acceptable than the alleged shifting of income by affected corporations.

Opposition of Foreign Governments - The inconsistency of the states' use of worldwide unitary taxation with international trade treaties is an issue which is of grave concern to the business community as well as to government. This committee is surely aware that no other foreign government utilizes a method, such as unitary, which reaches out to tax income beyond its jurisdiction. Such a practice is inconsistent with trade treaties and has generated criticism from the leaders of many of America's trading partners.

These foreign governments have expressed opposition to the use of unitary based on many of the same factors which concern American businesses -- most notably the states' taxation of income already taxed in foreign countries, and the costs and burdens associated with the preparation of unitary returns, particularly when operations within the United States account for only a small percentage of the unitary group's total operations.

The business community as a whole is concerned about this issue because of the possibility that trade opportunities in foreign countries may be lost if these countries restrict United States imports as a retaliation against the states' use of unitary. Even though a company may not be directly affected by unitary taxation, it may be negatively affected by these lost trade opportunities.

Multinational corporations -- which are already negatively affected by unitary taxation -- face the prospects of even greater impact or costs if foreign governments choose other forms of retaliation. Although aimed at the unitary states, such actions will likely actually directly affect multinational corporations doing business within the foreign country. For example, the British government is considering a bill which would withdraw tax rebates now given to United States multinationals that manufacture in Great Britain. The

affected corporations -- not the unitary states themselves -- would be the direct losers if such measures are taken.

Impact on Economic Development - One of the most important issues relating to unitary taxation is the implications on future investment within unitary jurisdictions. The rates and the means by which states tax a corporation's profits are important factors in the industrial site selection process, and are becoming even more important as the use of unitary by the states increases.

This fact was clearly documented in Florida by the State's Department of Commerce. The Department testified in Florida hearings that the impact of Florida's tax was negatively affecting the State's economic development efforts. In trade missions, industrial site selection conferences and in contacts with prospective industrial recruits, Department representatives found that at least half of the companies brought up the subject of Florida's unitary tax and indicated that it would have a negative effect on their corporation's considerations of Florida. Although Florida's unitary tax has only been in effect a little more than a year, current reports show that foreign investment in the State is declining. State officials are unsure to what extent unitary may have generated this decline.

If only a relatively small number of states utilize unitary taxation, the result will be a shifting of new United States and foreign investment away from unitary states and into those states which do not utilize the unitary method. The aggregate investment in the United States as a whole may be relatively unaffected.

However, if the use of unitary taxation becomes widespread among the states, both American and foreign corporations may begin to redirect their new investments away from the United States. For a company such as Motorola, the real impact of this method of taxation is substantial and clearly negative. For other companies considering expansion -- particularly non-U.S. companies -- the mere perception of what unitary taxation is and does may prevent them from locating in Florida or any other unitary state.

Possibility of Adoption by Other Countries - If the use of unitary apportionment continues within the United States, there is also the possibility that some countries may choose, instead of retaliating in other means, to react by adopting forms of unitary taxation within their own tax structures. Each country would, undoubtedly, structure a form of unitary which is most advantageous in terms of revenue generation based on its unique characteristics.

Again, the actual impact would fall, not on the unitary states themselves, but on the affected multinational companies. These companies would experience increased costs, both in terms of actual tax payments and in terms of the even greater administrative costs and burdens associated with the preparation of unitary returns meeting the requirements of foreign countries.

It is certainly possible that, under this scenario, foreign governments may require sensitive information which neither the affected corporations nor the United States government may wish to release. As long as American states continue to utilize a taxing mechanism which violates international trade policies, it would be difficult, if not impossible, for the United States government to affect the requirements adopted by its trading partners.

The issues discussed above reflect some of the objections which the business community has voiced on the use of worldwide unitary apportionment by any state. These issues have been debated in virtually every state where unitary has been considered or is in effect.

There were, however, other unique aspects of Florida's adoption of unitary which made it even more abhorrent to the business community:

Means of Adoption - Florida's corporate income tax code is relatively new, having only been in existence since 1971. At the time of initial adoption, there were extensive hear-

ings and opportunities for inputs from the business community. Subjects such as unitary apportionment, taxation of foreign source income and others were debated fully, and a tax policy which suited Florida's economic development strategies was developed. A conscious decision was made to piggy-back Federal tax returns to as large an extent as possible in order to minimize compliance costs for corporations and administrative and enforcement costs for the State. Consequently, Florida's tax policies were perceived by the business community to be fair, equitable and relatively easy to administer.

As mentioned earlier, Florida's recent adoption of unitary taxation was a rushed act with virtually no opportunity for input by the business community. One Florida government official appropriately described its passage as a "Raid on Entebbe approach." The special session was announced on a Thursday. The implementing bills were drafted, with no input from affected companies, over the weekend and first made available the following Monday. Although both the Senate and House held brief public hearings, it was clear that these hearings were perfunctory, and the State moved forward with passage that Tuesday in spite of strong and vocal opposition from the business community.

This action served to severely impact the good working relationship which had developed between the business community and the State government, and this deterioration has continued in the subsequent months.

Inequity of Impact - The funds generated by Florida's adoption of unitary taxation were intended for educational improvements from which the entire business community would benefit. However, a very small portion of the business community has been forced to shoulder the full cost -- with corporate tax liabilities often more than doubling. Of the 160,000 corporations subject to and filing a Florida corporate income tax return, it is estimated that only 1,500 to 2,000 corporations are affected by the changes in Florida's tax code, with the major impact falling on approximately 500 companies.

The fact that the funds were to be used for education also complicated the issue, as opposition to the tax and its passage was initially incorrectly construed as opposition to the educational improvements which the revenues were intended to implement.

Retroactivity - Florida's new tax provisions, passed in mid-July 1983, were retroactive to fiscal years beginning on or after September 1, 1982. Thus any corporation with a fiscal year ending on August 31, 1983 -- only six weeks later -- was fully subject to the new law as if it had been in effect for the entire fiscal year. Revised tax estimates and estimated payments based on the new law were required within six weeks of its passage. The tax changes were extremely complex, State rules and regulations were promulgated in an extremely rushed manner, and many definitions and interpretations of the new law had still not been resolved at the time it went into effect.

No Evidence of Abuse in Florida - Although proponents of unitary frequently aver that such taxation is necessary to prevent corporations from shifting income to avoid state taxation, State officials admitted that there had been no evidence of such abuse within Florida. State officials further admitted that the State had never attempted to use existing mechanisms -- specifically Internal Revenue Service audit programs pursuant to Section 482 of the IRS Code -- to review for such alleged abuse. Florida's corporations have found it inequitable and unreasonable to place cumbersome and costly unitary requirements on the entire business community in an effort to control possible, but undocumented abuses of a few.

Complexity of Florida's New Tax Provisions - Although the greatest amount of attention has been placed on Florida's adoption of the worldwide unitary apportionment method, the bills adopted by Florida in mid-1983 also contained other major changes in Florida's tax policies, including changes such as:

- Elimination of deductions for foreign source income, such as dividends from controlled foreign corporations.
- Elimination of the exemption for income generated by export sales.
- Adoption of throw-back provisions.
- Adoption of provisions providing a distinction in the treatment of business vs. non-business income.

Certain aspects of these tax changes are extremely complex, and they affect companies in a variety of ways. Often, the changes were combined under the general label of "unitary taxation", even though some of the provisions were actually totally separate from the concept of unitary apportionment.

Uncertainty Associated with Revenue Estimates - Throughout the 14 months since initial passage, it has been virtually impossible to determine how much revenue will be generated by the changes in Florida's tax code. Initial estimates were developed using rough extrapolations of revenue estimates in California and were based on assumptions which proved, under closer scrutiny, to be highly questionable.

This inability to determine even reasonably precise revenue estimates reflects the uncertainties and instabilities which are introduced into a state's tax structure when its business community is combined with (often totally unrelated) operations around the world. Many of the states which have adopted unitary taxation in recent years have found that the revenues generated by the tax were far less than originally estimated. Because of the complexity of the taxation method, it is also often several years before revenues are generated on a stable basis.

These revenue uncertainties have made the efforts to obtain repeal even more difficult. Legislative leaders have determined that there must be replacement revenues to continue the funding of the educational improvements. However, as the estimates associated with unitary have been revised numerous times since initial passage, it has been difficult to determine what replacement mechanisms will be appropriate in amount.

Incompatibility with Florida's Economic Development Strategy - In recent years, Florida has put major effort and resources into attracting to the State the very types of employers which will often be the most severely impacted by the new tax provisions. The State has been especially aggressive in recruiting corporate and regional headquarters, research and development facilities, and international trade facilities.

Prior to the adoption of unitary taxation, the State's efforts had been very successful. Since passage, the State has not changed its economic development strategy, even though, as mentioned earlier, at least half of the State's contacts now indicate that Florida's adoption of unitary taxation would have a negative effect on their corporation's considerations of Florida.

These additional factors have surely added fuel to the fires of opposition in Florida. However, the intensity and duration of the opposition signify that it is the underlying inequities inherent in the unitary method of apportionment which form the bases for the opposition, not merely the method of passage or other perceptions of its impact. Florida's business community has made it clear that the push for repeal will not subside until the issue is satisfactorily resolved for both United States and foreign-based multinationals.

Florida's business and government leaders are committed to full repeal of all unitary taxation, recognizing that the basic flaws and inequities in the unitary method of apportionment apply equally on a domestic as well as on a worldwide basis. Solutions which resolve the concerns of foreign governments and the foreign business community at the expense of American-based companies, as many of the suggested forms of domestic or waters-edge unitary would do, have not been considered acceptable solutions by Florida's Legislature.

It appears likely that full repeal of all aspects of unitary taxation will be accomplished in Florida in the very near future. Overwhelming majorities of both the Florida

House and Senate have voted for full repeal; it was only differences between the two chambers on the replacement revenues which prevented full repeal from being accomplished during the 1984 Legislative Session. The Leadership of the two Chambers now appears to be close to resolving these differences.

Therefore, Federal pre-emptive legislation may not be necessary to resolve the unitary issue in Florida, as the State's leaders appear committed to repeal. However, the problems and controversies associated with the use of unitary taxation by the states are of such magnitude that satisfactory solutions must be found, with a mandate from the Federal government if other states are not able or willing to find acceptable solutions on their own.

It is important that the Federal government speak with one voice on issues relating to foreign commerce. The opposition to unitary by foreign governments and by the American and foreign business communities are generating a controversy which is, in and of itself, disruptive and antagonistic. America's overall international relations must not be jeopardized by the continued use of a taxation mechanism so widely held to be inappropriate and inequitable.

A 1982 report by the United States General Accounting Office entitled "Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving" concluded that the inconsistencies between the tax policies of the various states create issues in terms of an unacceptable level of administrative burden and uncertainty and too high a risk of over- or undertaxation. GAO further concluded that the states cannot be expected to have the necessary balanced perspective, and the courts can address the issues only on a case-by-case basis. The GAO therefore recommended Federal standards for these issues, suggesting that only the Congress is capable of striking the needed balance between the states' right to tax and the Federal interest in interstate and international tax policy issues arising from state taxation.

Motorola appreciates the interest and concern of the Senate Committee on Foreign Relations on this issue, which is of such critical concern to America's business community.

Senator HAWKINS. Thank you very much.
Dean Lanzillotti.

STATEMENT OF ROBERT F. LANZILLOTTI, PROFESSOR OF ECONOMICS AND DEAN, GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF FLORIDA; FORMER CHAIRMAN, GOVERNOR'S UNITARY TAX STUDY COMMISSION, STATE OF FLORIDA, GAINESVILLE, FL

Mr. LANZILLOTTI. Thank you very much, Senator. I am honored and pleased to be invited to appear here today to present the findings of the Governor's Unitary Tax Study Commission. I would like to submit a copy of my statement for the record and a copy of this report, if it please the Senator.

Senator HAWKINS. It pleases the Senator.

Mr. LANZILLOTTI. In order to facilitate the proceedings, I would just briefly summarize the prepared statement. You will note in my statement that I make reference to the fact that the study commission actually reviewed more tax issues than the unitary method proper, and the charge to the commission also was to review the matter of senate bill 3-C in Florida with particular concern for what constituted sensible tax policy consistent with the economic development goals of the State.

We addressed a number of the issues that have arisen this morning in the course of testimony by previous witnesses—fairness and equity considerations, compatibility with the strategy for economic development in the State, the business community's perception of unitary, whether worldwide or water's edge, the burden question, compliance issues, as well as the comparative experience of other States. The full report of the commission addresses itself to all of these questions.

I would also like to point out on behalf of the commission that this is one of the most comprehensive analyses of the unitary tax issue. We held five public meetings around the State. We received extensive written and oral testimony—some 32 hours—from witnesses, both private and public sectors, large and small businesses, affected and unaffected corporations.

In short, the testimony and the analysis that the commission made, and just good common sense, indicated to us that the State of Florida was risking huge amounts of current and future capital investment in the State that would have had positive effects in terms of employment, personal income, corporate income, ad valorem tax revenue, for a relatively small and an uncertain amount of revenue accruing from senate bill 3-C, the unitary tax.

Our principal recommendation, which I would like to underscore here this morning, was that Florida discard any form of unitary taxation, since most of the problems associated apply as well to its use on a domestic or water's edge basis. In short, unitary taxation, whether domestic, water's edge, or worldwide, mandates an artificial shifting of income from one corporation to another and from one State to another.

A specious argument that has been advanced—I believe it came up earlier in the course of this committee's deliberations—is that the unitary method is necessary in order to preclude companies

from using their corporate structures to immunize large portions of their income from State taxation.

We inquired of the department of revenue in Florida whether there were in fact abuses, and the officials of the State Department of Revenue said they could not report any. Furthermore, we were advised that the current IRS mechanisms—that is, the audit programs under section 482 of the IRS Code—were adequate to address and correct any abuses.

Some of the testimony I heard this morning—I believe it was from California—indicated that they wished to shift the burden to the taxpayers to make an appeal if there has been some mistake in terms of the tax assessed from the State, for example, to appeal under section 482 to the corporations, a new procedure which they have outlined.

We found in Florida, this commission of 19 persons appointed by the Governor, with the advice and consent of the legislative leadership—these were academics, businesspersons, and just general citizens—that there was a widespread perception of inequity, instability and unpredictability in State tax policy as a result of senate bill 3-C and that major planned investments were placed on hold or cancelled outright.

We were aware, Senator, of the deliberations of the Worldwide Unitary Tax Working Group. Indeed, I should point out that one factor which influenced the commission in its conclusions was that the Working Group did not appear to be able to reach a consensus on unitary tax issues, and the report they issued confirms that any form of unitary taxation would cause such severe damage to economic development prospects in Florida to justify our conclusion of a full repeal of Florida's unitary tax.

Finally, as an economist I would urge this committee to be cautious of any actions it might take to be sure that existing problems generated by unitary taxation by States, especially the taxation of foreign-sourced income, are not solved by placing American firms at a competitive disadvantage with foreign trading partners. I think this would not only be unfair, it would be unwise economic policy.

Thank you, Senator.

[Mr. Lanzillotti's prepared statement and the report of the Florida Unitary Tax Study Commission follows:]

STATEMENT OF DR. ROBERT F. LANZILLOTTI
 PROFESSOR OF ECONOMICS AND DEAN
 GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF FLORIDA
 FORMER CHAIRMAN, GOVERNOR'S UNITARY TAX STUDY COMMISSION
 STATE OF FLORIDA

Before

COMMITTEE ON FOREIGN RELATIONS
 UNITED STATES SENATE

September 20, 1984

Mr. Chairman, I am honored and pleased to be invited to testify before this Committee on the findings, conclusions, and recommendations of the Governor's Unitary Tax Study Commission, State of Florida, completed in March, 1984, a copy of which is submitted for the record.

I understand the Committee is interested in developments in Florida as a kind of "case study" of the issues surrounding the "unitary" method of taxation. I should stress two fundamental points regarding developments in Florida: (1) this matter has entailed more tax issues than the unitary method proper, and (2) the Florida Study Commission was under a charge to review the matter with particular concern for what constituted sensible tax policy consistent with the economic development goals and policies of the State.

In 1983, Florida enacted not simply a "new unitary tax law," but a new method of taxation, representing a sharp break with the Florida Tax Code in place since 1971. It actually consists of several components, only one of which is the "unitary" tax provision:

- (A) The Worldwide Combined Reporting section contains
 - (1) a provision mandating the application of an "apportionment formula" to calculate the "fraction" of net income attributable to the corporation's Florida

activities relative to the corporation's total business activities "everywhere" (worldwide) and (2) a Unitary provision requiring that the income from all parts of a "unitary" group be considered together for apportionment purposes.

- (B) All former Foreign-Source Income Exemptions were eliminated: both income from export sales, and "passive" income from foreign sources, [i.e., interest, dividends, rents, royalties, and capital gains].
- (C) A "Throwback Rule" under which certain sales are attributed to Florida if (1) the goods are shipped from Florida to a jurisdiction in which the Shipper is not subject to any income tax, or (2) the buyer is the United States Government.
- (D) Finally the Florida statute created a distinction between regular "business" income earned and "other" income [interest, dividends, rents, royalties, and capital gains]. Unlike the treatment of business income [which is apportioned using a "3-factor" formula], however, "non-business" income is subject to the unapportioned Florida tax if corporate headquarters are located in Florida.

The Florida Commission's conclusions and recommendations can be summarized very briefly:

In order to repair negative perceptions about Florida's business environment and to regain the industrial development momentum existing prior to July 1983, the Commission recommended amendments to Florida's corporate income tax law [Chapter 83-349] to (1) restore the federal tax base and separate accounting method of taxation utilized in Florida prior to 1983, (2) eliminate both the "throwback

of sales" provision and the distinction between "business" and "non-business" income, (3) restore the exemption covering "passive" foreign-source income, and (4) continue to tax income from export sales (except from products manufactured in Florida).

The Florida Commission addressed the following aspects of the State unitary tax statute: (I) fairness and equity considerations; (II) compatibility with Florida's existing strategy for economic development; (III) the impact on the business community's perception of Florida's business climate; (IV) compliance and administrative burdens for corporations and the State of Florida; (V) the comparative experience of the states that normally mandate some form of the unitary method; and (VI) what corporate-based tax replacement source should be adopted, should the Commission's review indicate a change or modification to the unitary tax law is needed.

The Commission held five public meetings around the State, received extensive written and oral statements, including 32 hours of testimony from over 40 witnesses from both the public and private sectors.

Fairness and Equity of the Unitary Method: Despite what some observers argue, no unambiguous conclusion emerges from an analysis of the "fairness" or "equity" of the unitary tax to corporate taxpayers. Proponents defend the unitary tax as the "fairest" method for determining taxable corporate income. At the same time, the Florida Commission heard extensive testimony from affected companies outlining various kinds of inequities, including double taxation and disproportionate increases in tax liabilities which are discussed at length in the Commission's Report. Moreover, the Commission found that a relatively small number of Florida companies

[approximately 150] were singled out in 1983 to generate the estimated \$95 million in new corporate tax revenue, not as a result of any change in their profitability, but merely as a consequence of the diversified nature of their organizations, whether multistate or multinational.

Considerable confusion exists today regarding the number of states using a "unitary method of taxation," because of a failure by various parties to state precisely what is meant by "unitary." Is combination of income required across corporate lines? Does the concept apply formula apportionment for the income of a single corporate entity or all affiliated entities? Is the statute limited in application? Is the statute elective or mandatory? Under what conditions? Is unitary normally required or rarely required? Is unitary widely used under the state's statute, or used only selectively in unique situations?

The Florida Commission found that most of the provisions of the State's unitary tax statute are not compatible with the State's existing strategy for attracting new industry. For example, the business/non-business income distinctions discourage either maintaining or re-locating corporate headquarters to Florida, since all non-business income is allocated to Florida for tax purposes (rather than apportioned as is the case with regular business income).

In short, extensive testimony received, plus economic analysis and plain common sense indicated to the Commission that the State was risking huge amounts of current and future capital investment in Florida, with substantial positive economic "multiplier" effects [employment, personal and corporate income, ad valorem tax revenue and other tax revenue] for a relatively small and uncertain amount of unitary tax revenue.

Therefore, the Commission concluded that Florida should "set its own course" with an appropriate tax strategy for attaining the State's long-term industrial development goals and the economic benefits associated therewith. The Commission's principal recommendation was that Florida discard any form of unitary, since most of the problems and objections generated apply as well to its use on a domestic basis. Unitary taxation, domestic or worldwide, mandates an artificial shifting of income from one corporation to another and from one state to another. Put differently, unitary taxation changes the direct relationship between the situs of where the income is generated and where the income is being taxed. Thus, the use of the unitary concept may subject more income to taxation for some corporations and less income subject to taxation for other corporations.

One specious argument advanced for the unitary method is "to preclude companies from using their corporate structure to immunize large portions of their income from State taxation." The Florida Commission inquired of various witnesses from the State Department of Revenue about this issue, and was advised there is no evidence that Florida has lost revenue as a result of abuses by corporate taxpayers reporting under separate accounting requirements. The Commission was further advised that current IRS mechanisms [the audit programs in section 482 of the IRS code] are adequate to address and correct any abuses which may exist.

The Florida Commission found that the State's adoption of the unitary method of taxation in 1983 generated such widespread perception of inequity, instability, and unpredictability in State tax policy that major planned investments in the State were placed on "hold" or cancelled outright. The

Commission determined that other tax alternatives represented a wiser and more consistent policy for the State.

In conclusion, I should note that the Florida Commission was aware of the deliberations of Secretary Regan's Worldwide Unitary Taxation Working Group. Indeed, one factor that influenced the Florida Commission in reaching its conclusions was that the Federal Working Group report confirms that any form of unitary taxation would cause such severe damage to the economic development prospects for Florida as to justify the Commission's recommendation for full repeal of Florida's unitary statute.

Finally, as an economist I would urge this Committee to be cautious in any actions it might take to be sure that the existing problems generated by unitary taxation by states, especially the taxation of foreign-source income, are not solved by placing American firms at a competitive disadvantage with our foreign trading partners. This would not only be unfair, it would be unwise economic policy.



GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

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Robert F. Lanzillotti, Dean · 904-392-2397

March 2, 1984

The Honorable Bob Graham, Governor
 State of Florida
 The Capitol
 Tallahassee, Florida 32301

Dear Governor Graham:

On behalf of the Florida Unitary Tax Study Commission, it is my pleasure to transmit to you this report on the Commission's deliberations, conclusions and recommendations regarding the corporate income tax provisions of Senate Bill 3-C.

The issues relating to these provisions are extremely complex, and Commission members devoted a tremendous amount of personal time and effort reading, listening to testimony, studying the issues, and deliberating the proper course of action to recommend to the State. As Chairman, I am grateful to the members for their willingness to serve on the Commission, and to contribute their time and expertise in varied areas to the study of this important subject.

It is the hope of the Commission that you and the Legislature will accept and support these recommendations, and enact legislation to implement them as early as possible in the 1984 Legislative Session. If the Commission can be of further assistance to you or the Legislature on this important subject, please do not hesitate to call upon us.

Respectfully yours,

Robert F. Lanzillotti, Chairman
 Unitary Tax Study Commission

RFL:rcm

**REPORT OF
FLORIDA UNITARY TAX
STUDY COMMISSION**

Robert F. Lanzillotti, *Chairman*

W. O. Birchfield
J. A. Boyd
Hyatt Brown
J. Clint Brown
Paul Cejas
John "Jack" Cooney

Howard Davidson
Jeff Davidson
Tine Wayne Davis, Jr.
Fred O. Drake, Jr.
Ralph Haben
Marshall Harris

Jerry Hesch
W. Richard Johnston
Burke Kibler
Mildred W. Ravenell
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Renee Ann Wright

March, 1984

TABLE OF CONTENTS

	<u>Page</u>
1. INTRODUCTION	1-1
2. BACKGROUND INFORMATION	
A. Formation of the Commission	2-1
B. Pre-Commission Activities	2-4
C. Explanation of the Income Tax Provisions of Senate Bill 3-C	2-9
3. COMMISSION ACTIVITIES	3-1
4. COMMISSION RESPONSES TO GOVERNOR'S QUESTIONS. . .	4-1
A. Question #1: Is the unitary tax fair and equitable to corporate taxpayers?	
1) Commission Findings.	4-2
2) Commission Conclusions	4-20
B. Question #2: Is the unitary tax compatible with Florida's strategy for economic development?	
1) Commission Findings.	4-22
2) Commission Conclusions	4-32
C. Question #3: Does the unitary tax have such a negative image that it does damage to Florida's economic climate?	
1) Commission Findings.	4-34
2) Commission Conclusions	4-46
D. Question #4: What are the compliance and administrative requirements of the unitary tax?	
1) Commission Findings.	4-48
2) Commission Conclusions	4-58
E. Question #5: What has been the experience of the dozen other states -- such as California, Minnesota, Massachusetts, Utah -- which have lived with this tax longer?	
1) Commission Findings.	4-60
2) Commission Conclusions	4-66
F. Question #6: If the conclusion of your review indicates a change or modification to the unitary tax law is needed, what is the corporate-based replacement revenue source?	
1) Commission Findings.	4-68
2) Commission Conclusions	4-76

TABLE OF CONTENTS (Continued)

	<u>Page</u>
5. COMMISSION CONCLUSIONS AND RECOMMENDATIONS. . . .	5-1
6. APPENDICES	
A. Copy of Senate Bill 3-C, Chapter 83-349, Laws of Florida.	6-1
B. Florida "New" Unitary Corporate Tax, 57 Fla. B. J. 573 (Oct. 1973), discussing select provisions of the new law	6-13
C. Governor's Press Release Announcing Formation of the Governor's Unitary Tax Study Commission, Nov. 11, 1983	6-18
D. Synopses of Governor's Unitary Tax Study Commission Members.	6-29
E. Selected News Articles on Pre-Commission Activities.	6-31
F. Commission Meeting Reports.	6-50
G. Summary Index of Materials Comprising the Public Record of the Governor's Unitary Tax Study Commission.	6-67
H. Map of United States Showing States Which Have Adopted a Worldwide Combined Reporting System.	6-72
I. Numerical Examples of the Impact of the Commission Recommendations on Hypothetical Corporations.	6-73
J. Proposed Statutory Language to Implement the Recommendations of the Governor's Unitary Tax Study Commission.	6-79

1. INTRODUCTION

This report summarizes the activities, deliberations and conclusions of the Governor's Unitary Tax Study Commission (the "Commission"). This Commission was created by Florida Governor Bob Graham in November 1983 to study the impact on the State of Florida of the corporate income tax provisions contained in Senate Bill 3-C ("SB 3-C"), passed by the Florida Legislature in a special session in July 1983. The bill was passed to provide funding for improvements to Florida's public education system. After enactment, a storm of protest developed concerning the income tax provisions of SB 3-C, based on information which had not been known at the time of its passage.

The corporate income tax provisions contained in SB 3-C are explained in greater detail in Section 3 of this report, as well as in Appendix B. A copy of the bill is also attached as Appendix A. To briefly summarize, SB 3-C made the following major changes to Florida's corporate income tax code:

1. Adoption of the worldwide unitary reporting method, or combined reporting, to determine the amount of income subject to Florida taxation. (This replaced the separate accounting method used by the State since the original passage of the corporate income tax code in 1971.) And redefinement of the denominator of the apportionment formula to include worldwide payroll, property and sales.

2. Elimination of Florida's prior exemption for all forms of foreign (non-U.S.) source income.
3. Adoption of a throw-back rule which defines certain governmental and other sales as Florida sales for apportionment purposes, in place of the prior destination test.
4. Adoption of the formula contained in the Uniform Division of Income for Tax Purposes Act (UDITPA) which creates a distinction between the apportionment of business income and the allocation of non-business income.

The Governor charged the Commission with the task of analyzing the potential impact of the new tax provisions on the State, particularly in terms of the State's economic development activities. The Commission was also directed to evaluate the impact of the new tax system on affected corporate taxpayers, particularly in terms of the fairness or equity of the tax. And finally, should the Commission conclude that all or part of SB 3-C should be modified or changed, the Commission was asked to recommend corporate-based replacement revenues to maintain the level of educational funding provided for by the bill. The Governor made his staff available to the Commission in all regards. The Governor's charge to the Commission is covered in more detail in Section 3 of this report.

It is important to note that, although called a Unitary Tax Study Commission, it was apparent that it would be necessary for the Commission to study all aspects of SB 3-C, not just the

unitary reporting requirement. The Florida Department of Revenue and members of the business community repeatedly advised the Commission that the various components of SB 3-C are, indeed, highly inter-related. In fact, reliable estimates of the revenue impacts of the individual components of SB 3-C were not readily available during the life of the Commission, and are probably not obtainable at all.

Finally, it should be noted that the Commission attempted, to the extent possible, to limit its deliberations to the Florida impacts. Simultaneous to this Commission's deliberations, a federal study group was analyzing the national and international ramifications of the states' usage of worldwide unitary taxation. Although it was not possible to totally eliminate some of these considerations from this study, the Commission did not dwell to any extent on the impacts on international trade or policy -- except to the extent that such concerns could be expected to have a direct impact on Florida and its economic climate.

2. BACKGROUND INFORMATIONFormation of the Commission:

The Governor's Unitary Tax Study Commission (the "Commission") was formed by Governor Bob Graham, in consultation with Senate President Curtis Peterson and House Speaker H. Lee Moffitt. The formation of the Commission was announced by Governor Graham on November 11, 1983.

The Governor appointed the Commission to study the impact of the unitary tax program, Senate Bill 3-C, Chapter 83-349, Laws of Florida ("SB 3-C"), which was enacted by the Florida Legislature on July 12, 1983. The Governor explained: "I am appointing this commission out of a willingness to determine the full impact of the unitary tax and out of a commitment to keep Florida as the State with America's best climate for business." (Governor's press release, 12/2/83). A copy of the Governor's initial press release announcing the formation of the Commission is contained as Appendix C.

The Governor appointed nineteen individuals from the business, professional and academic sectors of Florida to the Commission. On November 11, 1983, the Governor appointed Dr. Robert F. Lanzillotti, Dean of the University of Florida College of Business Administration, as chairman of the

Commission. The other eighteen members of the Commission were appointed on December 2, 1983. (On February 5, 1984, one of the commissioners, J.J. Daniel, withdrew from the Commission due to another gubernatorial appointment. On February 20, 1984, W. O. Birchfield was appointed to replace Mr. Daniel.) The names of the individuals appointed to the Commission and a brief synopsis of their backgrounds are contained in Appendix D.

The Governor's charge to the Commission was framed in terms of six questions:

1. Is the unitary tax fair and equitable to corporate taxpayers?
2. Is the unitary tax compatible with Florida's strategy for economic development?
3. Does the unitary tax have such a negative image that it does damage to Florida's economic climate?
4. What are the compliance and administrative requirements of the unitary tax?
5. What has been the experience of the dozen other states - such as California, Massachusetts, Minnesota, Utah - which have lived with this tax longer?
6. If the conclusion of your review indicates a change or modification to the unitary tax law is needed, what is the corporate-based replacement revenue source?

The Commission's mission was further clarified in comments made by Governor Graham to the Commission at its first meeting. The Governor provided a context and background for the Commission by explaining the State's motivation for enacting SB 3-C:

"I indicated that at a national level, the essential motivation for the unitary tax was the internationalization of the economy of America. In Florida, the essential motivation was the desire of our State to reach a higher level of excellence in our education system."

The Governor further explained:

"The unitary tax is more than an issue of taxation. It is more than an issue of State fiscal policy. It reflects the necessity of having a stable revenue basis, if the public services which are critical to the future of this State are to be financed.

The issue before us here today is how do we assure that all parts of this State who benefit by the quality of public services make appropriate contributions to their support? And, what is the fairest, most equitable way in which to contribute to the attainment of our economic goals of prosperity and the support of necessary public services to assist in achieving that prosperity -- what is the proper course for Florida?" (Governor's charge to the Commission, 1/4/84).

The Governor's charge provided the framework for the Commission's deliberations, and the context within which its mission was to be pursued.

Pre-Commission Activities:

Some background information is required to understand the necessity for the creation of a study commission only four months after the passage of SB 3-C.

During the 1983 legislative session, the need for improvements to the State's public education system was identified as a top priority. Unfortunately, throughout the regular session and two extended sessions, the Legislature was unable to reach agreement on a revenue package to fund these educational programs. The Legislature finally passed a "continuation" budget, with no major increases in educational funding. Governor Graham vetoed this portion of the budget on June 30, 1983, thereby leaving the State's school systems without a budget for the 1983-84 school year. Meanwhile, on June 27, the U.S. Supreme Court upheld California's use of the unitary taxation method in Container Corporation of America v. Franchise Tax Board, __ U.S. __, 51 U.S.L.W. 4987 (1983).

On July 7, Governor Graham announced that he was calling the Legislature into a special two day session, beginning July 12. At this point, a final bill had not yet been drafted, and most members of the business community were unaware

of the components of the tax. There had been limited discussion earlier in the regular session about eliminating the foreign source income exemption and the new tax package was described in official press releases as one which only taxed foreign source income.

Prior to July 11, when pre-session committee hearings were held, no legislative body or committee had ever discussed the concept of unitary apportionment. The draft statute which was to become SB 3-C was made public for the first time on Monday morning, July 11, 1983. That bill was then considered at three legislative committee hearings, held within twenty-four hours of each other, on July 11 and 12. It passed both the Senate and the House in the following twelve hours. As enacted, it attempted to raise revenue from corporate income taxes, and other revenue sources not relevant to the Commission's deliberation.

Most affected businesses were not aware of the provisions contained in SB 3-C until after the bill had passed. As news of its contents and its probable economic impact to Florida became known, members of the business community began to push for immediate repeal of the corporate income tax provisions of the bill, at another special session of the Legislature, if possible.

In the government and legislative arenas, several public hearings were held. A first analysis of the bill (later identified widely as the "One hot day in July" speech) was presented to the Florida Industrial Development Workshop on July 19, 1983, by Arthur J. England, Jr., Esq., the draftsman of Florida's original income tax code. A first public hearing on the bill took place on October 18, 1983, when the Governor and the Florida Cabinet received testimony from seventeen speakers from the business community and foreign governments opposing SB 3-C. At that meeting, Secretary of State Firestone proposed a Cabinet resolution urging replacement of the worldwide unitary and foreign source income provisions of SB 3-C with alternative sources based on a finding that the law damaged Florida's pro-business climate. The Cabinet voted 5-1 against the resolution.

On October 24, 1983, the Dade County (Miami) legislative delegation held a public hearing in Miami on SB 3-C. Several business groups and business representatives testified before the delegation, urging the repeal of SB 3-C. A spokesman for the Florida AFL-CIO and a member of the Dade County School Board testified in favor of the new law.

On November 2, 1983, the Senate Finance, Taxation and Claims Committee and the Senate Appropriations Committee held a joint hearing in Tallahassee on SB 3-C. Sixteen individuals representing Florida businesses, government, trade associations, and economic development groups testified in opposition to the income tax provisions of SB 3-C. Three people testified in

favor of the unitary method of reporting: Ken Cory (Controller of California), Eugene Corrigan (Executive Director of the Multistate Tax Commission), and Jerry Glover (on behalf of the National Small Business Association, Washington, D.C.). The Senate Finance, Taxation and Claims Committee heard additional testimony at a meeting on December 7.

The House Finance and Taxation Committee has held no public hearing on SB 3-C since its passage. Its chairman, however, received technical presentations from his staff and conducted a workshop with business representatives in conjunction with his staff and the House Speaker.

In the business sector, two coalitions were formed for the purpose of presenting a united position for the repeal of SB 3-C. One group, denominated simply the Ad Hoc Group, composed of more than thirty multinational corporations which have Florida operations, testified and wrote extensively against the new tax provisions. Another group, the Florida Tax Coalition, is comprised of over thirty civic and trade organizations from all parts of the State. The member organizations of the Florida Tax Coalition represent thousands of Florida firms, many of which are small businesses not directly affected by the unitary tax.

In addition to these new groups, existing groups came out publicly against SB 3-C. Associated Industries of Florida, Inc. (AIF) opposed SB 3-C and widely urged its repeal, as did the

Florida Manufacturers' Association (FMA), an umbrella organization consisting of seven regional manufacturers' associations. AIF is an organization of long history which represents the voice of business in Florida, and FMA comprises approximately 1200 member companies employing over 165,000 Floridians.

The Florida Chamber of Commerce also became a vocal advocate for the repeal of SB 3-C. Additionally, many city and county governments, and local chambers of commerce, adopted resolutions urging the repeal of SB 3-C.

During this period, the Governor and legislative leaders received hundreds of letters and telegrams from the business community urging reconsideration of the new legislation. The Commission received a sampling of those letters from Secretary of State George Firestone and from Associated Industries of Florida, Inc. The letters contain strong statements from the chief executive officers of many of the country's largest corporations relating to the specific impact of SB 3-C on their business location and expansion decisions in Florida. These letters are contained in the public records of this Commission's activities, along with the correspondence and testimony sent directly to the Commission.

Examples of this pre-Commission background have been compiled in the form of a sampling of the news articles and reports on this issue between July and December of 1983. This compilation is contained in Appendix E of this report.

Explanations of the Income Tax Provisions of Senate Bill 3-C:

The provisions of SB 3-C are highly technical and complex in nature, and the reader is referred to the statute itself, Chapter 83-349, Laws of Florida, and to the Florida Department of Revenue (DOR) for explanatory details of the corporate income tax code and regulations. However, some explanation of the provisions is required to understand the Commission's findings and conclusions.

First, it is important to dispel the notion that SB 3-C is simply the "new unitary corporate tax law", because SB 3-C actually has several components, only one of which is the worldwide combined reporting, or unitary tax provision. Although the majority of the written and oral testimony received by this Commission related to the unitary tax component of SB 3-C, the Commission received testimony about and considered all of the major aspects of SB 3-C.

(1) Worldwide Combined Reporting

This component of SB 3-C, also referred to as the unitary tax provision, has two major and related, aspects -- the worldwide aspect and the combined reporting aspect.

(a) The worldwide aspect

The apportionment formula used in Florida to determine the amount of net income subject to the 5% Florida corporate income tax is a combination of weighted fractions

which compare the taxpayer's Florida activities to the total of the taxpayer's activities "everywhere". Under the prior law, "everywhere" activities (or the denominator of the apportionment formula fraction) related only to the 50 states and the District of Columbia. SB 3-C changed the formula to include all foreign activities in the definition of "everywhere" activities, including those in U.S. territories and possessions, Puerto Rico and any foreign country and its political subdivisions. SB 3-C also repealed an exemption in Florida's prior tax law for all income from foreign sources.

By enacting worldwide apportionment and repealing Florida's prior exemption for all income received from foreign sources, the State eliminated the nation's broadest exemption for the income received from foreign activities. Most states do tax foreign source income to some extent. A number of states, however, including several in the southeast, exempt the passive types of income (interest, dividends, rents, royalties and capital gains, typically), as Florida did before the enactment of SB 3-C.

(b) The combined or unitary reporting aspect

Prior to the enactment of SB 3-C, Florida utilized federal taxable income as the starting point for its corporate tax base, based on so-called "separate accounting". SB 3-C revised the tax base upon which corporate income is computed by introducing the concept of a "unitary business group". A corporate business now subject to tax in Florida is required to

report its worldwide net income, and the worldwide net income of other all related (owned 50% or more) corporate entities in a "unitary group".

The Commission was advised that all affected taxpayers will not experience increases in Florida corporate income tax liability as a result of these worldwide combined reporting requirements. If the operations of the unitary group members outside of Florida are more profitable than the Florida operations, tax liability in Florida will indeed increase. Conversely, if the unitary group operations outside of Florida are less profitable, tax liability in Florida decreases. It may be expected that approximately 80 percent of the affected companies will experience tax increases as a result of the adoption of worldwide unitary reporting, with the taxes of the remaining 20 percent being reduced. (Testimony of Gerald Goldberg, Executive Director of the California Franchise Tax Board, 2/6/84).

(2) Elimination of the Exemption for Income Generated by Export Sales

Along with the broad foreign source income exemption of prior law, SB 3-C eliminated the exemption for income generated by export sales. Prior to the enactment of SB 3-C, Florida allowed corporate taxpayers to exempt all income generated from export (non-U.S.) sales, as an inducement to the development of international trade in Florida. Although commonly referred to as "foreign source income", this income is less inclusive than

the passive income mentioned above. Florida was the only state which provided this type of income exemption in full.

(3) Throw-back of Sales

SB 3-C amended Section 214.71(3)(a)1 to provide that sales will now be attributed to Florida if the goods are shipped from Florida and (a) the purchaser is the United States Government, or (b) the taxpayer is not subject to a tax on or measured by income in the state to which the sale would otherwise be assigned. In contrast, under the prior law, for purposes of the apportionment formula, attribution of sales to Florida was determined by the destination of the goods. This change causes a larger portion of a company's sales to be defined as Florida sales and, as a result, causes more of the company's worldwide income to be apportioned to Florida for taxation purposes. Since Florida applies a double weight to the sales factor in its apportionment formula, the impact of the throw-back rule is greater than in other states.

(4) Non-business Income

Based on the UDITPA formula found in other states, SB 3-C creates a distinction between income earned in the taxpayer's regular course of business (business income) and income earned outside the taxpayer's regular course of business (non-business income). The general rule of the new law allocates non-business income to the state of the taxpayer's commercial domicile. Business income is apportioned, using the three factor formula.

(5) Other features of SB 3-C

As earlier stated, SB 3-C contains other tax provisions which do not relate to the corporate income tax code. These non-corporate aspects of SB 3-C will not be specifically discussed in this report because they did not generate any significant testimony or other written communications.

The Commission found, however, that the four corporate tax components outlined above were the aspects of SB 3-C which have caused considerable controversy in the business community. The Commission thus concluded that it would be both naive and derelict in its responsibilities to consider and report on only the unitary, or worldwide combined reporting, aspect of SB 3-C. Therefore all of the major corporate tax aspects of SB 3-C were reviewed.

A copy of SB 3-C is contained as Appendix A to this report. Additionally, a commentary on the major provisions of SB 3-C, which was published in the Florida Bar Journal, is contained as Appendix B.

It should be noted that, during the 1983 regular legislative session, another corporate income tax bill was passed, Committee Substitute for Senate Bill 916, Chapter 83-291, Laws of Florida ("CS SB 916"). CS SB 916 contains provisions relating to estimated tax requirements, penalties and interest. Some of the DOR studies and analyses received by the Commission included discussion of these provisions, in addition

to the provisions of SB 3-C. However, the Commission received no other testimony on the changes enacted by CS SB 916, and no reference to these provisions is contained in the Commission's recommendations.

3. COMMISSION ACTIVITIES

The Commission's deliberation process included holding a series of public hearings in various locations around the State of Florida during January, February and March of 1984. At these public hearings, the Commission received extensive written and oral statements from any and all persons interested in presenting testimony to the Commission. The agenda, Commission attendance, names and affiliations of the witnesses who testified before the Commission and action taken by the Commission at each of the public hearings are contained in Appendix F of this report.

The vast majority of witnesses who testified before the Commission advocated the full repeal of SB 3-C. As expected, many of the witnesses who requested to testify before the Commission represented directly affected multinational corporations who are engaging in corporate activities in Florida. However, the Commission also received considerable testimony in opposition to SB 3-C from representatives of Florida corporations which are not directly affected by the new law, but who, as suppliers of the affected corporations, are impacted by the multiplier effects. In addition, the Commission received testimony in support of repeal from economic development agencies, associations and chambers of commerce.

Five witnesses testified before the Commission in support of SB 3-C. Only one proponent was a Florida resident -- Judy Johnson of the League of Women Voters of Florida. The other proponents were Ken Cory, the Controller of the California Franchise Tax Board (FTB); Gerald Goldberg, Executive Director of the California FTB; Eugene Corrigan, the Executive Director of the Multistate Tax Commission; and Jerry Glover, a representative of the National Small Business Association in Washington D.C. The Commission specifically invited Messrs. Cory, Goldberg and Corrigan to testify because of their experience with unitary tax in other states and their well-known support of the unitary tax system. The Commission also received written pro-unitary testimony from the Washington D.C. office of AFSCME (American Federation of State, County and Municipal Employees).

The Commission was provided with a briefing package prepared by the Department of Revenue, and briefing information and testimony from the Governor's staff and staff members of various state departments. Representatives of the Florida Department of Revenue and the Governor's Office testified regarding the new tax components of SB 3-C and the revenue projections associated with the unitary tax system and other components of SB 3-C.

Additionally, Steve Mayberry, Director of the Division of Economic Development of the Florida Department of Commerce,

presented testimony about the impact of SB 3-C on Florida's economic development programs.

Of course, during the oral testimony portions of our public hearings, the Commission asked specific questions of the witnesses and, in that way, the Commission was able to refine the information and focus on developing data which was responsive to the six questions posed by the Governor. Since it was not possible to prepare a full transcript of all of the Commission hearings, cassette audiotapes of each of the hearings have been secured and are available as part of the permanent public record of the proceedings of this Commission.

In addition to the oral witness testimony presented at the public hearings, the Commission received a considerable amount of written correspondence, including letters, written testimony, reports, studies, newspaper clippings, journal articles and city and county resolutions. This written material was received from a variety of sources, including Florida and non-Florida businesses, Florida local chambers of commerce, Florida business associations and organizations, Florida legislators, foreign government representatives and nationally-recognized tax authorities and economic development experts. This written correspondence, which was quite voluminous, is an indication of the considerable interest of the business and professional community in this issue. Because the specific views and concerns of those who communicated with the

Commission may not otherwise be available to the public, the written material has been organized and indexed, and the original documents have been delivered to the Governor's office for preservation. A copy of the summary index to the written material received by the Commission as of February 27, 1984 is contained in Appendix G.

Four public hearings were held before the full Commission. Copies of the written testimony and other written communications, to the extent feasible, were made available to all Commission members. At the February 6, 1984 Commission meeting, two subcommittees were appointed. A drafting subcommittee composed of four Commission members was appointed to coordinate and organize the drafting of this report. A revenue alternatives subcommittee, composed of five Commission members, was appointed to review and refine the alternative revenue sources to SB 3-C. Both held public hearings.

Each subcommittee reported to the full Commission on February 17, 1984. At that time, the Commission agreed on the content and scope of its report, and authorized drafting of a full report and implementing statutory language. On March 2, the full Commission met for final deliberations, and those present and voting unanimously approved this report.

Section 4 of this report responds to the questions posed by the Governor. That section, setting forth the findings, analysis and conclusions of the Commission, is substantiated by numerous citations to and direct quotations from the oral and written testimony and other communications received by the Commission. It should be noted, however, that these citations are only a representative sampling of the wealth of material considered by the Commission.

4. COMMISSION RESPONSES TO GOVERNOR'S QUESTIONS

As mentioned in Section 3 above, in forming this Commission the Governor indicated that there were several specific areas he wanted the Commission to address during its deliberations. Specifically, the Governor posed six questions to the Commission:

1. Is the unitary tax fair and equitable to corporate taxpayers?
2. Is the unitary tax compatible with Florida's strategy for economic development?
3. Does the unitary tax have such a negative image that it does damage to Florida's economic climate?
4. What are the compliance and administrative requirements of the unitary tax?
5. What has been the experience of the dozen other states - such as California, Massachusetts, Minnesota, Utah - which have lived with this tax longer?
6. If the conclusion of your review indicates a change or modification to the unitary tax law is needed, what is the corporate-based replacement revenue source?

Much of the Commission's analysis and discussion was, therefore, conducted within the framework of these six questions. This section of the report presents the Commission's findings and conclusions as they relate to each of these questions.

GOVERNOR'S QUESTIONS ONE:IS THE UNITARY TAX FAIR AND
EQUITABLE TO CORPORATE TAXPAYERSCOMMISSION FINDINGS:

The question of fairness and equity was by far the most difficult for the Commission to address. This was largely because fairness could be addressed from several different perspectives: Is it fair to burden only a relatively small number of corporate taxpayers with the new revenue needs of Florida? Is the tax fair based on comparisons with the tax policies of other states? Is the new tax fair relative to pre-SB 3-C provisions?

The Governor's charge to the Commission provided the context in which the fairness issue should be pursued. The Governor explained that unitary taxation was adopted in Florida as "a last minute solution to a Legislative problem: Florida needed a revenue source to pay for reforming public education." (Governor's charge to the Commission, 1/4/84) The Legislature had historically derived approximately 10 percent of the total State's general revenue from the corporate income tax, and an additional \$95 million was required to meet the educational goals from that source. Other revenue sources had not been acceptable to the Legislature, so that unitary and foreign source income taxation seemed to be the only solution. (Governor's charge to the Commission, 1/4/84).

The Governor asked the Commission to address the fairness issue in relation to the different types of businesses within the State:

"One is the business which is totally within the State of Florida; second is the business which is within the State of Florida and other states within the United States; a third would be the business which was within the State of Florida, possibly other states, and foreign countries; and the fourth would be a foreign corporation which was doing business in the State of Florida. Now, the question, applying those traditional standards of tax policy would be, are we treating all of those various economic competitors in an equitable and uniform way to further the goal of neutrality in terms of state treatment of those various forms of corporate organizations, in terms of their competitiveness in the market place?" (Governor's charge to the Commission, 1/4/84).

Applying the traditional standards of tax policy, Dr. Virginia Wilcox-Gok, an economics professor at the University of Florida, addressed the issue of the fairness of unitary taxation on a theoretical basis. She addresses the fairness issue as follows:

"The concept of horizontal equity is fundamental in analyzing tax systems: Tax systems can be considered to be horizontally equitable if taxpayers of equal ability-to-pay are taxed equally. The answer as to whether Florida's unitary tax is equitable depends upon whether it can be supposed that the U.S. multinationals operating in Florida were artificially shifting profits to subsidiaries by way of

internal accounting practices in order to pay taxes in jurisdictions with lower tax rates. If so, then it was certainly the case that horizontal equity was being violated in Florida, and the unitary tax has rectified the situation. Whether this has been the case is not clear. However, it certainly is to be expected that a profit-maximizing firm will organize its production such that taxes (and all other costs) are taken into account, hence, this certainly is not implausible."

Dr. Wilcox-Gok concludes that:

"I think the issue of fairness is somewhat empty, however, if in the long run those firms which are "fairly" taxed decide to relocate in a state without a horizontally equitable tax system. In the extreme, one could expect Florida to drive out U.S. multinationals, leaving us with a unitary tax and no firms to impose it on." (Letter, 2/5/84).

Looking at the existing tax policies of the State, it is readily apparent that there are many instances where horizontal equity is not maintained. Sales tax exemptions, homestead exemptions for ad valorem taxation, and other tax exemptions are inconsistent with pure horizontal equity. Within the State's corporate income tax code examples also exist, such as the exemptions for Subchapter S corporations and the first \$5000 of income for all corporations. The question then becomes, does the enactment of SB 3-C enhance, or detract from, the degree of horizontal inequity which existed in the code prior to July 1983?

Jerry Glover, representing the National Small Business Association in Washington, D. C., testified that, on a nationwide basis, small businesses are concerned about the issue of unitary taxation. According to Mr. Glover, the fear is that, if worldwide unitary taxation is not maintained, the tax burden will be shifted to small businesses. He testified that "small and medium-sized businesses already pay a much heavier, more disproportionate burden." (Testimony, 1/18/84)

However, other testimony received by the Commission indicated that in Florida the opposite may be true. The briefing package prepared for the Commission by the Department of Revenue contained a draft statement relating to who is affected in Florida by the unitary tax. The statement contained the following facts:

- ** As of June 30, 1983, there were approximately 160,000 corporations subject to and filing a Florida Corporate Income Tax Return. These 160,000 corporations excluded other than first year "Sub-S" and exempt corporations.
- ** Of the 160,000 corporations, 40,000 have paid corporate income tax. The other 120,000 were first year "Sub-S" entities, corporations earning less than \$5,000, or corporations that had shown losses for the taxable year. (Note also that sole proprietorships, partnerships and other non-incorporated businesses are not subject to corporate income taxation.)

** The Department of Revenue estimates that, of this figure, 1,500 to 2,000 corporations will be subject to the unitary tax, and that 541 of these corporations now appear to be strongly unitary by nature and structure.

("Third Rough Draft (per B. Zuna) of Response to Who is Affected in Florida by the Unitary Tax", contained in the briefing package prepared by the Department of Revenue).

The briefing package also contained information on the relative corporate income tax burden in 1981. It referenced a survey of 340 returns from the largest taxpayers with tax liabilities representing approximately forty percent (40%) of the total paid to the State of Florida. Less than one percent (1%) of the corporate taxpayers generated forty percent (40%) of the revenue. ("Revenue Estimates and Collections to Date", contained in the briefing package prepared by the Department of Revenue).

The Department of Revenue used a different statistic in relation to a survey sent out on the impact of unitary taxation. Dr. Edgan A. Fresen of the Department indicated that they had identified 152 corporations most likely to be affected by the new tax provisions. These 152 corporations account for thirty-four percent (34%) of all corporate tax revenues.

Regardless of the statistic used, it is clear that an extremely small number of corporate taxpayers, who already contribute a tremendous amount of the State's corporate tax revenues, were affected by the new tax provisions, and that the additional burden on each affected company is expected to be

extremely significant. These statistics indicate that the new tax laws do not follow the principles of broad-based, equitable taxation being sought by the State. In essence, a small number of companies has been singled out to generate \$95 million in new corporate revenue, not as a result of any change in their operations or profitability, but merely as a result of their multinational nature.

Many companies spoke of their tax liabilities doubling or tripling, but some spoke of even greater increases. For example, John M. Dwyer, Manager of Cadillac Gage Company in Cocoa, Florida, reports a tax liability increase of over 1700 percent. (Letter, 1/23/83).

Although most of the testimony on this question dealt with fairness to the affected companies, Delray Beach City Commissioner Malcolm Bird provided testimony on the unfair impact of the new tax provisions on local governments. He provided estimates of the lost state and local tax revenues associated with IBM's decision to not move forward with its proposed lease of an office building complex in Delray Beach, which would have employed approximately 600 persons. He provided the following figures for the lost revenue associated with one of the buildings affected by IBM's decision:

Ad Valorem Tax Losses:	
Palm Beach County	\$25,493.40
South Florida Water	2,393.40
South County Hospital	2,242.20
Palm Beach School Board	41,596.80
City of Delray Beach	<u>31,752.60</u>
Total	\$103,478.40

Commissioner Bird pointed out that the biggest loser is the School Board -- the very agency the law was passed to support. He also provided estimates on lost ad valorem and sales tax revenues associated with the employees who would have worked in the IBM complex. (Testimony, 2/17/84).

Both opponents and proponents recognized that certain problems exist with the use of either unitary or separate accounting techniques. In fact, Container Corporation of America v. Franchise Tax Board, decided on June 27, 1983, which provided the basis for Florida's passage of worldwide unitary apportionment, contains the following statement:

"Both geographical accounting and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory."

The Supreme Court upheld the right of the State of California to use formula apportionment, but did not deem it to be a better method than separate accounting.

"Of course, even the three-factor formula is necessarily imperfect. But we have seen no evidence demonstrating that the margin of error (systematic or not) inherent in the three-factor formula is greater than the margin of error (systematic or not) inherent in the sort of separate accounting urged upon us by appellant."

Proponents of the unitary method, such as Eugene Corrigan, Executive Director of the Multistate Tax Commission,

asserted that unitary apportionment is necessary to enable the State to collect taxes on the appropriate portion of an interstate or international corporation's income. He suggests that,

"absent the unitary method, it is possible to utilize corporate form to immunize great amounts of income from your tax administration reach." (Testimony, 1/18/84).

Opponents of the unitary method of apportionment contended, on the other hand, that existing mechanisms -- specifically IRS audit programs pursuant to Section 482 of the Code -- are adequate to address and correct any abuses which may exist. Although perceived to be somewhat ineffective in the past, it was pointed out that recent reports indicate that substantial changes have occurred in the IRS audit programs involving large corporations and that the Service has gained considerable expertise and effectiveness in its Section 482 audit program. ("Report to the Associate Commissioner (Operations) by the Assistant Commissioner (Examinations)"). Business representatives indicated resentment that the entire multinational business community has been burdened with cumbersome and costly requirements in an effort to control the alleged abuses of a few.

The Commission received no direct evidence that Florida had been deprived of revenue as a result of abuses by corporate taxpayers under pre-SB 3-C separate accounting requirements. The Department of Revenue testified that the State had never

attempted to use the Section 482 audit tools available to the Department under Florida's prior law. (Testimony of Jim Barger, Chief, Bureau of Audit Selection, 1/4/84). Opponents of the unitary method questioned whether audits under the combined reporting method would be any less complex.

The charges of tax immunization by multinational corporations imply that these corporations artificially manipulate their corporate structure or form to avoid state taxation. However, the Commission received evidence to the contrary. Several witnesses referenced extremely high income tax rates in foreign countries, which would logically encourage a corporation to keep profits in the U.S., and not vice-versa. Gulf Oil Corporation testified that some foreign oil-producing companies have "income taxes" which take 96 percent of the pre-tax income used by the California Franchise Tax Board. (Letter, 2/2/84). Tax rates such as these cannot be expected to encourage any artificial movement of profit to these high-tax countries, and yet the affected corporations testified that much of their income is in such environments.

A variety of other witnesses also addressed the differences between legitimate foreign operations and the charges of artificial paper transfers of profits. Witnesses reported that subsidiary foreign corporations are often a necessary prerequisite to gain access to certain foreign markets, due to government policy or customer preference. Some witnesses asserted that multinational corporations are dealing

in global environments, and in most cases, cannot compete effectively if they have only U.S. operations.

In any case, however, it is significant that the need to have unitary apportionment as a means to control tax avoidance by Florida corporate taxpayers did not appear to have been a factor in the decision to enact SB 3-C. This justification appears to have developed after the fact, and was not suggested in or substantiated by any other testimony or data received by the Commission about Florida's tax experience.

Several other issues of fairness were developed. Corporations provided examples from other states where the use of worldwide unitary apportionment generated double taxation because of problems with the use of the apportionment formula, and because the state does not allow a deduction or credit for foreign taxes.

In the Container case, the Supreme Court acknowledged that double taxation can occur with worldwide unitary taxation. The Court found that in the Container situation, formula apportionment yielded 14 percent more income to California than would the separate accounting method. The Court concluded this is:

"a far cry from the more than 250% differences which led us to strike down the state tax in Hans Rees' Sons, Inc., and a figure certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business."

Testimony before the Commission from affected companies related to differences in apportionment of income well in excess of 14 percent. This distortion was attributed to several inherent characteristics of the unitary tax concept. For instance, it was asserted that there are inequities created by the assumption, inherent in worldwide formula apportionment, that property, payroll and sales factors are consistent worldwide. If all factors were equal throughout the world, apportionability would also be expected to be reasonably equal. Testimony indicated, however, that the factors are not equal, and the income assigned to each taxing jurisdiction does not accurately reflect the derivation of income. Patrick J. Doherty, Controller of Castle & Cooke, asserted:

"the worldwide unitary method of taxation creates a tax burden that bears no resemblance to the income or loss from activities within such state." (Letter, 1/9/84).

Charges of inequity arose most frequently in relation to cases where property and payroll factors are lower in foreign operations than in the unitary taxing state, and hence the foreign profitability is higher. Under the formula apportionment method, the unitary taxing state is allocated a higher level of income than under separate accounting. Since foreign countries do not use formula apportionment, there are no offsetting underallocations of income to lower-cost jurisdictions to correct these inequities.

Companies provided a variety of explanations for the legitimate differences in profitability among operations around the world. Gulf Oil Corporation provided data showing that an oil well in one of the foreign oil-producing countries produced about 300 times the oil that could be produced from an oil well in California, yet the property and payroll associated with each of the two operations may be reasonably similar. Since oil wells are part of the property factor, and since oil production results in income, this means that when applying the three factor formula to worldwide income, the California numerator of the property factor will be overstated. The result is that the taxable income attributed to California will be greatly overstated. Gulf testifies that this factor, combined with the fact that California does not provide a deduction or credit for foreign taxes, generates overallocation of income to California ranging from 491 percent to 2,586 percent.

Mr. C. H. Daubert, Manager of State Legislation for Gulf, indicates that, while these statistics refer to California for the years 1966 through 1974, they depict distortion and international multiple taxation applicable to other Gulf cases now pending at the administrative level in several states which practice the worldwide unitary method. They also would have application to any Gulf litigation in Florida resulting from imposition of tax under the State's new worldwide unitary tax law. (Letter, 2/2/84).

Dallas Hurston, Assistant Treasurer of the Coca-Cola Company, testified that:

"in all cases, worldwide combination apportions to the foreign subsidiaries, in the case of the Coca-Cola Company, less income than the foreign countries have already subjected to taxation."

He stated that 1982 schedules presented to the President's Task Force on the issue showed that:

"the total income taxed by foreign countries combined with the income subjected to tax by the state, exceeds total worldwide income of the Coca-Cola Company by \$98.4 million. Worldwide Unitary applied to the Coca-Cola Company by Florida alone would result in Florida double taxing \$23 million of income already taxed at higher rates by foreign governments."

Other specific examples provided by Coca-Cola indicated that:

"In 1978, the Coca-Cola Company had about \$425 million of income subject to foreign taxation. Of this amount, nearly \$114 million was also taxed by unitary states with no allowance for foreign taxes already paid on these earnings. Thus 26.7% of the Coca-Cola Company's foreign income was subjected to both foreign taxation and domestic taxation by the states. One state's audit for the year 1974, subjected to taxation 67.9% of the total income produced by the German subsidiary, already taxed at very high rates." (Testimony, 1/18/84).

Shingo Moriyama, Executive Vice President of Kyocera International, a Japanese company, said the firm sold two of its California factories after that state insisted on taxing its earnings from Japan.

"The tax came to 101 percent of the net profits of the California operation. I can't think of any country in the world that demands you pay a tax higher than your profits " (Quoted in the Ft. Lauderdale News, 2/18/84).

The Honorable Makoto Utsumi, Minister for Financial Affairs for the Japanese Embassy, testified that Japanese accounting principles prevent the devaluation of assets by market value. As a result the assets value in Japan tend to be underestimated when taxable income is apportioned. Similarly, he testified that cultural differences affect the relative value of the payroll factor. In Japan, many business-related expenses are typically paid for by the employer, rather than by the employee, as they are in the U.S. Therefore, salary levels in Japan would tend to be lower, and the apportionment method presents a "very distorted picture" when applied internationally. (Testimony, 1/18/84).

Testimony also indicated that higher profitability is necessary in offshore operations to compensate for other factors. Motorola's testimony referenced the need to compensate for significant political risks which often are associated with foreign operations. (Testimony, 1/18/84). William Shelly, Economic Consultant to the Florida Chamber of Commerce,

testified regarding the need for higher rates of return to offset the erosion of net income caused by the higher inflation rates which exist in most foreign countries. (Testimony, 1/18/84).

Some foreign countries are threatening retaliatory measures if states continue the use of worldwide combined reporting. The effects of such retaliatory measures could generate further inequities for affected companies. For example, Michael Grylls, Member of the British Parliament, testified to the Commission that the patience of the British Government is "rapidly running out". He is pressing for the inclusion of a clause in this year's Finance Bill, which would:

"have the effect of withdrawing the right of a company whose principle place of business is in a state that uses the system of unitary taxation to claim the refund of advance corporation tax. This tax is payable to HM Treasury on the company's United Kingdom activities. Over the last three years to December, 1983, repayments of United States corporations totalled 531 million pounds." (Testimony, 2/17/84).

The inequity of unitary reporting requirements with respect to start-up operations was also frequently referenced in letters and testimony. Although new operations often lose money in their early years of operation, under unitary reporting the entire income of the unitary business group is immediately brought into the apportionment for the state in which the new operation is located. The new operation could be faced with

substantial state tax liabilities, even though operating in a loss situation.

Theoretically, of course, this increase in income attributable to the state where the new operation is located is offset elsewhere. If all jurisdictions used unitary reporting, there would be corresponding reductions in tax liability elsewhere as a result of the introduction of the new, non-income generating operation. However, since few jurisdictions use unitary reporting, the actual impact is often a net increase in tax liability, not only for the operation, but for the entire business group. Many witnesses testified that this inequity would serve to decrease the number of new investments being made in the state -- particularly from companies which do not already have operations within Florida.

California recognizes this aspect as being one of the chief complaints against the use of unitary reporting. California Controller Ken Cory testified that between 70 and 80 percent of the arguments against the unitary accounting principle relate to the start-up issue. As a consequence, he is now supporting a bill which would allow new facilities to be exempted from the unitary accounting requirement for the first five years. This bill is being discussed as an economic incentive tool, but Cory indicates that he is using it simply as a vehicle for establishing dialogue with the business community on what their real concerns are on unitary

taxation. (Testimony, 2/6/84). In contrast to Cory's statement, Steve Mayberry, Director of the Economic Development Division of Florida's Department of Commerce, testified that the "start up cost" issue was not a focal concern of business prospects his staff has contacted. (Testimony, 2/6/84). Consequently, a modification of SB 3-C providing a limited moratorium on the use of unitary reporting for new businesses would not alleviate the perception of unfairness expressed by prospective Florida business investors.

The Commission also received considerable testimony regarding the inequities generated by the dramatic changes in the treatment of foreign source income. It was generally agreed that Florida's pre-SB 3-C exemptions for foreign source income were the most generous in the nation. These provisions were the result of Florida's economic policy decision to actively pursue new investment, particularly in the areas of international trade. The State chose to adopt provisions which were more attractive than, and not just competitive with, those of other states. The exact extent to which these provisions contributed to Florida's economic development in recent years as compared to other factors cannot be determined. However, it seems generally accepted that these provisions did contribute to the State's success in attracting new firms, and that some firms located in Florida largely as a result of these provisions.

SB 3-C changed Florida's treatment of foreign source income from the most generous in the nation to the most

restrictive. Although most other states do tax foreign source income to some extent, many of the southeastern states exempt large portions of foreign source income -- particularly the taxation of dividends, interests, royalties, and other "passive" income.

E. Paul Casey, President & Chief Executive Officer of Ex-Cello-O Corporation in Cocoa, Florida, expressed the reaction of many businesses to these dramatic changes. He stated that the repeal of foreign income exclusion and the initiation of the sales throw-back rule increases the company's state income tax expense tremendously both in terms of percentage and absolute dollar amounts. He contended that:

"[A]n increase of the magnitude we're facing, particularly without some warning to allow us to figure the cost into the price of our products, strikes us as being most unfair." (Letter, 12/19/83).

The Commission received relatively little testimony on the throw-back rule, but most of what was received was negative. Arthur England, representing an Ad Hoc Group of multinational corporate taxpayers, characterized the impact which the throw-back rule has as follows:

"The notion of 'nowhere sales' which allegedly supports throw-back sales is not a valid characteristic of business deceit. Rather, if the term is to be used at all, it is simply a recognition of the policy decisions of other sovereigns not to tax, as Florida now does, those sales transactions which they have the clear authority to tax. In practical effect, Florida's throw-back

rule penalizes business for the tax policy decisions of other states and countries." (Testimony, 1/18/84).

The Coopers & Lybrand Study for Illinois found no firms which favored the use of worldwide unitary taxation which did not also benefit on the bottom line from the approach. However, the study did find respondents who actually benefited from worldwide combined reporting, but nevertheless opposed it on grounds of principle. ("Economic Impacts and Tax Alternatives Associated with Worldwide Combined Reporting for the State of Illinois," Coopers & Lybrand, September 1982). These companies appear to be addressing the issue of "fairness" in their philosophical opposition to the concept -- in spite of the potential of individual fiscal benefit.

COMMISSION CONCLUSIONS:

There is not a simple, clear answer to the question of whether the unitary tax is fair and equitable to corporate taxpayers. Opponents and supporters both acknowledge that there are potential problems with either arm's length or unitary accounting, and this conclusion was supported by the Container decision. California officials strongly defend their history with unitary, but acknowledge that the conclusions are somewhat subjective. Ken Cory summarized the disagreement best when he said that the difference between accounting under the so-called arm's length standard and under the unitary method is just a difference in philosophy. (Testimony, 2/6/84).

Affected corporations are solidly lined up on the anti-unitary side of the philosophy. They provide documentation of double taxation and inequities in use of the formula apportionment method, and point to inequities in forcing an extremely small portion of the business community to shoulder major long-term financial burdens to fund programs which benefit the entire business and residential community.

The Commission concludes that, in the extreme, even if all of the fairness arguments advanced by the affected multinationals must be discounted as being self-serving, it is still clear that the provisions of SB 3-C are generating a controversy of such magnitude that it is having a negative impact on the State. (These impacts are addressed in greater detail in the Commission's answers to Questions 2 and 3.)

The issue of fairness and equity to the affected taxpayers is therefore overshadowed by the issue of what is in the long-term best interest of the State.

GOVERNOR'S QUESTION TWO:IS THE UNITARY TAX COMPATIBLE WITH
FLORIDA'S STRATEGY FOR ECONOMIC DEVELOPMENT?COMMISSION FINDINGS:

In recent years, Florida has developed an effective economic development strategy, involving an action plan to improve Florida's business climate and aggressive recruitment of new investment for the State. Success has been achieved on both counts.

Florida has shaken its "fun and sun" image, and has replaced it with recognition as the State with the nation's best business climate. This is evidenced by the number one rating given for the past two years in the Alexander Grant Surveys. (Testimony of Steve Mayberry, 2/6/84).

In spite of this impressive standing, the Florida Department of Commerce, which has responsibility for the State's economic development activities, recognizes that continued effort is required to maintain this competitive advantage.

"We must continue to maintain this competitive edge. We must continue to look for ways to improve the perception of Florida as a good place to do business. We must continue to explore new ways to strengthen and diversify our economy. All of the state's economic development programs must work in harmony." (Marketing Plan, Florida Department of Commerce, Bureau of Industry Development).

The State has also been successful in its recruitment activities. The Department of Commerce recruits primarily among Fortune 500 companies, and has identified seven targeted industry groups: aviation, defense, communicating equipment, medical instrumentation, drugs and pharmaceuticals, food processing and corporate headquarters. (Marketing Plan, Florida Department of Commerce, Bureau of Industry Development). Recruiting efforts have included trade missions led by Florida Governors, other State officials, private industry groups and economic development councils.

Since 1980, the efforts of the Department of Commerce have generated new projects in the State amounting to nearly \$7.2 billion in capital investment, with over \$2 billion invested in each of the past two years. Initial employment for these new facilities is nearly 60,000, with projected employment of 131,000. (Letter from Larry Sassano, Development Representative Supervisor, Division of Economic Development, 2/6/84).

The testimony revealed that adoption of the worldwide unitary reporting method and the taxation of foreign source income are not compatible with either aspect of this economic development strategy. While the testimony relating to the fairness issue focused primarily on the issue of worldwide unitary taxation, from an economic development standpoint, both the unitary provisions and the changes in foreign source income

taxation generated a strong adverse response from the business sector witnesses. Although the evidence may be equivocal in certain areas, one fact became undeniably clear from our deliberations -- the passage of the SB 3-C corporate tax provisions has created a tremendous controversy, and the perception of Florida as a good place to do business has been substantially eroded as a result. The overwhelming majority of the testimony received by the Commission, from both affected and nonaffected parties around the State, reflected this feeling. This perception directly conflicts with the "competitive edge" philosophy established in the Department of Commerce's Marketing Plan.

Secondly, the corporations which the State has selected to recruit (primarily Fortune 500 companies) are very likely to be negatively impacted in a substantial manner by the new tax provisions, since most are multinational. Steve Mayberry, Director of the Division of Economic Development, Florida Department of Commerce, testified that the State has not shifted its marketing strategy, and is still actively seeking multinationals and Fortune 500 companies. He also testified that the business community believes Florida has now changed its favorable tax climate. (Testimony, 2/6/84). Therefore, it seems likely that as a result of the new tax law, the success of the State's future recruitment activities will be reduced.

Corporate representatives noted that the provisions of SB 3-C create a particularly strong disincentive for companies

to bring non-revenue producing operations, such as research and development facilities or corporate or regional headquarters, into Florida. Moving such operations into the State increases the property and payroll portions of the apportionment formula, with no change in worldwide profitability or income, thus generating a net increase in taxation. The recruitment of headquarters and research and development facilities has been an important factor in the State's economic development strategy, and these tax provisions are particularly damaging to this aspect of the State's strategy.

The testimony received by the Commission indicated that the adverse impact of the new tax provisions on Florida's economic development is a state-wide problem. Concerns about the negative economic impact of SB 3-C, and general opposition to the new tax provisions, were voiced by business groups and local government representatives from all quadrants of the State. The broad base of the opposition is exemplified by the strong repeal-endorsing positions expressed by such groups as the Florida Manufacturers' Association, the Florida Tax Coalition and Associated Industries of Florida, Inc. The Florida Manufacturers' Association is an umbrella organization composed of manufacturers' associations from Brevard County, Central Florida, Lee County, Pinellas County, Sarasota-Manatee Counties, South Florida and Volusia County. The Florida Tax Coalition consists of more than thirty civic and trade

organizations from all geographic areas of the State, including the Gulf Coast World Trade Council, Jacksonville International Trade Association, Pensacola Area Chamber of Commerce, Pinellas Industries Association, Tampa Bay International Trade Council and the World Trade Center of Orlando. Associated Industries represents the voice of business in Florida. Its members, approximately 2,000 companies doing business for profit in Florida, employs over 60% of the State's private sector work force. The state-wide scope of the problem was further revealed by the range of local government groups that have determined that SB 3-C would negatively impact on the economic growth in their localities. The Commission received copies of repeal-endorsing resolutions and position statements adopted by local government groups from around the State, including the North Brevard Development Commission, Pensacola Area Chamber of Commerce, City of Boynton Beach, City of Boca Raton, Greater Sanford Chamber of Commerce, Jacksonville Chamber of Commerce, Economic Council of Palm Beach County, City of Delray Beach and Gainesville Area Chamber of Commerce.

The compatibility of the new tax provisions with the State's economic development strategy was also addressed by the Economic Development Advisory Council. This Council, which consists of eighteen high level business representatives from around the State, was established as an integral part of the

State's economic development activities and is charged with responsibility of advising the Governor and Secretary of Commerce on economic development programs, prospects and problems. The Council has expressed its concern with the impact of the new tax provisions in the form of a unanimously passed resolution calling for prompt repeal of the the new corporate tax provisions. The Council has found that:

- ** The new Florida tax law pertaining to "unitary" and "foreign source income" taxation is unfair and discriminatory in its application to the most desirable business and industry targeted by Florida to diversify the economy of this State.
- ** This problem is perceived to be of such severe magnitude that Florida business leaders on this Council and others have indicated they will find it difficult to fulfill their role of soliciting business and industry to Florida.
- ** Desirable corporations have indicated to members of this Council that they would not consider a Florida location due to the unfair nature of the "unitary" tax laws and the effect these laws will have on their multinational operations. (Economic Development Advisory Council Resolution, 9/22/83).

The relationship between state taxation policies and the industrial site selection process was addressed by a number of witnesses before the Commission. All recognized that tax policies are but one factor in the decision-making process.

However, Steve Mayberry, summarized why taxes are important in the locational decision as follows:

- ** "First, of all the quantifiable factors, it [taxes] is usually the one which can be most accurately projected and is usually compared separately as well as cumulatively.
- ** Second, it can vary significantly by state and locality. (For example: state rates of corporate income tax range from nil to 12 percent.)
- ** Third, it is most often the principal yardstick in determining whether a community and state have a positive attitude toward new industry or just a good public relations program. For example, when the citizens of Florida and the Florida Legislature endorsed the Governor's proposal to abolish inventory tax and provide local tax inducements (part of the "FIVE FOR FLORIDA'S FUTURE" package), it was heralded widely as a signal that Florida indeed backed up its words of warm welcome for industry."

He went on to point out that, although surveys indicate that taxes average only three to four percent of total annual costs for manufacturing projects, the Alexander Grant Study places a weighting of 26 percent on tax factors. (Testimony, 2/6/84).

Jon Shebel, President of Associated Industries of Florida, Inc., expressed the impact of tax policy in a slightly different way. He explained that, for plant-siting decisions,

in the final cut it is negatives which eliminate a state; the finalists will all have positives. He testified that:

"this is the biggest negative for multistate operations that you could possibly enter into." (Testimony, 1/18/84).

In September 1982, the accounting firm of Coopers and Lybrand conducted a study, including a survey of 100 businesses, for the State of Illinois, entitled "Economic Impacts and Tax Alternatives Associated with Worldwide Combined Reporting for the State of Illinois". The author of the study, economist Dr. Richard Cooper, appeared before the Commission and indicated that the economic conclusions for Florida would be similar to those reached for Illinois. Specifically he testified that:

"[A]lthough state and local taxes tend not to be a primary determinant of corporate location decisions, (1) neither are they unimportant and (2) they seem to be increasing in importance. The reasons for this increasing importance of state and local taxes in corporate location decisions are several fold:

(i) companies are paying more attention to all costs, including state and local taxes;

(ii) companies believe both that state and local [S&L] taxes will increase over time and that they will rise even further in proportion to their Federal taxes, thus placing greater emphasis on S&L taxes;

(iii) there is increasing concern about the consistency with which taxes are applied; and

(iv) perception about S&L taxes may be even more important than the actual tax liability itself. As I am sure you have discovered, the terms "unitary" and "worldwide combined reporting" in particular have come to take on an especially negative connotation. Indeed, I am sure you are aware of the negative press Florida has received in the past 6 months." (emphasis supplied) (Testimony, 2/6/84).

The Coopers & Lybrand Study found that companies were ready to back up their rhetoric with withdrawal decisions. They found case studies where companies actually moved jobs and facilities as a result of worldwide unitary reporting requirements. These examples were usually manufacturing or distribution facilities, and were less likely to be headquarters or sales facilities, although the study did find examples of headquarters or sales facilities being reduced in size as a result of the taxation.

Dr. Cooper concluded in his testimony before this Commission that:

"There is little doubt, however, that the decisions most readily affected are those involving new facilities, precisely the ones that many states are looking for to bolster their economic development." (emphasis supplied) (Testimony, 2/6/84).

Dr. Cooper acknowledges that, other than his study, relatively little formal economic analysis has been done on this issue. However, he indicated to the Commission that he believes that economists in general would agree with the conclusions of the Coopers & Lybrand Study.

The Coopers & Lybrand Study is, in fact, supported by economic theory. Dr. Virginia Wilcox-Gok, an economics professor at the University of Florida, analyzed the formal theoretical work which would relate to this issue. Dr. Wilcox-Gok explains that economic theory would suggest the following results:

"Let U.S. multinationals in Florida be operating in sector X and other firms in sector Y. In a competitive setting, firms in X can do little to adjust to the tax in the short run. The State is able to raise the expected revenues, and firms must bear the burdens of the tax. Of course, the short run is only long enough for firms to begin readjusting their assets in the State. It is in the longer term that we expect to see equalization of net rates of return in sectors X and Y. Since the unitary tax lowers the net (after-tax) rate of return in X, capital will shift to the untaxed sector (e.g., IBM may sell its Alachua assets to a firm not subject to the tax) and the rate of return in Y will fall and that of X rise until equality is again reached between the net rates of return in the two sectors (although the gross rate of return is higher in X)."

Dr. Wilcox-Gok concludes that:

"In the situation of a state unitary tax, even for firms in non-competitive positions, the possibility of higher profits will lure them to other locations as long as good substitute locations exist.... For plants in the state for which considerable fixed costs are involved, the impact is not likely to be observed immediately, but as long as close substitutes exist in the form of the other Southeastern states, theory does predict a definite long-term response. The competing states have become marginally more attractive." (Letter, 2/5/84).

The Commission heard from Delray Beach City Commissioner Malcolm Bird who testified about the relationship between the State's economic development and the viability of local governments. Commissioner Bird contended that if the effect of SB 3-C is to deter industrial development (which he believes it will), local governments will suffer. He estimated that each resident in his City contributes approximately \$100 in local taxes, yet it costs the City approximately \$271 to provide the local services required by that resident. Commissioner Bird concluded that it is essential that the State actively pursue the commercial and industrial development necessary to alleviate the revenue shortfall associated with residential development. Commissioner Bird corroborated the Coopers' Illinois study by citing a specific example of one company which has already left Florida for New York, because of SB 3-C. (Testimony, 2/17/84).

COMMISSION CONCLUSIONS:

The Commission concentrated its deliberations on the subject of the compatibility of the tax with the State's established economic development strategy. It was not this Commission's charge to re-evaluate what Florida's economic development strategy should be, or to recommend new tax policy for the State.

The Commission recognizes that it is the prerogative of the State to re-evaluate and change such policies as appropriate

over time. The testimony indicated, however, that the passage of SB 3-C made dramatic changes to the State's economic development potential, yet it was passed in the context of a revenue generator and not as the result of a thorough review of economic policy nor pursuant to a conscious decision to change the State's tax strategy.

The Commission concludes that the provisions of SB 3-C are not compatible with the State's strategy for economic development. Testimony indicates that future investment in the State and, to a lesser extent, the retention of existing investment, will be jeopardized by these provisions. Analysis of economic theory confirms this conclusion.

In essence, the State will be risking substantial amounts of future investment, with long-term positive multiplier effects, for short term, relatively small revenues. As reported by Dr. Cooper, Florida "should not look at unitary to raise revenue in the short run." (Testimony, 2/6/84).

Chris Wada of the Sony Corporation described the decision as being "\$95 million wise, \$1 billion foolish". (Testimony, 1/18/84). His analogy may well prove to be correct, and the Commission concludes that it is not a risk which is compatible with the State's long-term economic well-being.

GOVERNOR'S QUESTION THREE:

DOES THE UNITARY TAX HAVE SUCH A NEGATIVE IMAGE
THAT IT DOES DAMAGE TO FLORIDA'S ECONOMIC CLIMATE?

COMMISSION FINDINGS:

The overwhelming majority of the testimony received by the Commission indicated that the provisions of SB 3-C would have negative impacts on Florida's economic climate. The damage to Florida's economic climate may result more from the business community's negative perception of the impacts of the new tax provisions than the actual impact of tax provisions. However, it appears that the negative perceptions will influence corporate decisions, and thus the perceptions may become the reality in terms of Florida's economic development.

Along these lines, Steve Mayberry, of the Department of Commerce, testified that although Florida is competitive in terms of overall taxes on corporations and individuals,

"it is not the total amount of taxes that we are collecting from corporations which is the issue. Rather, it is the method by which we tax them." (Testimony, 2/6/84).

Ken Cory, Controller of California, also indicated that the perception of the unitary tax concept accounts for a significant amount of adverse reactions from the corporate community in California.

The perception issue also was repeatedly brought up in conjunction with the method of passage of the new tax provisions. Business representatives indicate that adoption of major changes in tax policy, with virtually no notice or opportunity for input, demonstrated little or no concern for the business community. Milt Fisher, Chairman of the Florida Tax Coalition (a group of 34 member organizations), describes it thus:

"We had the most harmonious government/business relationship that you could possibly imagine, and we created together an economic miracle in the Sunshine State. And what we see here in this unitary tax, in one hasty, foolish, unfortunate, well-intentioned moment, here in this town, as a penalty for success." (Testimony, 1/18/84).

To the extent that site selection and investment decisions are being impacted by the controversy, the line between perception and reality fades, and perception becomes reality. These tax provisions have already influenced some specific decisions. For example, International Business Machines Corporation (IBM) announced in February that it plans to sell nearly 2000 acres in Alachua County, near Gainesville, Florida, because it believes Florida's unitary tax has made the State an unattractive place to build corporate facilities. The company estimates that Florida's unitary tax raised the

company's estimated state income tax bill from \$5 million in 1982 to an estimated \$10.1 million in 1983.

"In this case, the unitary tax was the sole factor [in the decision to sell the property]." (Miami Herald, 2/3/84).

The fact that decisions of this type have been made within six months of passage indicate the magnitude of concern among affected companies.

Testimony indicated, however, that most site selection decisions take place over a period of several years. Thus the real impacts of the new law will not be felt for several years, and growth may even continue relatively unaffected in the near term. For example, Mary Lou Lackey, Regional Director of State Relations for Motorola, Inc., testified that:

"[Motorola is] now beginning occupancy of its new 320,000 square foot facility in Boynton Beach -- a project which has been in the planning and development stages for many years. When these new tax provisions passed in July 1983, one month before occupancy was scheduled to begin, it was obviously too late to change our plans.

This building was planned as the first phase of a major facility, and most of the infrastructure and site development work for the entire property was done in conjunction with this first phase. Therefore, Motorola will most likely continue to occupy and to expand its Boynton Beach facility to a level which justifies the major expenditures which have been invested in the property.

However, future site decisions and future jobs will clearly be affected. Our Florida operations have experienced rapid growth in recent years, and the search for our next major facility location will begin long before our current facilities are fully utilized. Florida's competitive position as we undertake this next site search will be dramatically reduced by these new tax policies, and it is much less likely that our next facility will be in Florida." (Testimony 1/18/84).

Testimony from the State Department of Commerce indicated the extent to which the issue is affecting the State's economic development activities. Steve Mayberry, Director of the State's Division of Economic Development, provided three quantitative measures of the degree of concern indicated by companies being recruited by the State.

** "Since July, our Bureau of Industry Development has conducted eighteen sales missions throughout the continental United States. During these sales missions, 375 companies were interviewed. Of those companies, many are totally domestic in their scope of operation. One hundred and fifty-nine are multinationals. Seventy-five or 47 percent of the multinationals volunteered concern over Florida's 'Worldwide Unitary Tax' system."

** "There is an organization known as the Industrial Development Research Council whose members are corporate real estate site selectors, predominantly from Fortune 500 corporations. We have been aggressively marketing the State of Florida to this group for about five years. At its last conference in

November 1983, representatives from our Bureau of Industry Development had meaningful discussions with some 200 members of this organization. Over one-half brought up the subject of our new "Worldwide Unitary Tax" and indicated that it would have a negative effect on their corporation's consideration of Florida."

** "We are currently working with 259 active projects from around the country. These companies have expressed a serious interest in a Florida location. These companies represent employment opportunities totaling 56,985. One hundred and four of these projects have indicated to us that the "Worldwide Unitary Tax" weighs negatively on their evaluation of Florida. These 104 companies represent employment opportunities totaling 22,794 jobs."

Mr. Mayberry went on to note that,

"Staff reaction is another way of getting a feel for the degree of the problem. Our reps indicate prospects are saying Florida has reversed our trend of pro-business attitudes. Some of the corporate real estate directors we have courted in recent years have become almost "Florida boosters" within their companies. These executives, in particular, feel we have caused them some embarrassment within their companies and, as a result, have discontinued their strong support of Florida as a business location." (Testimony, 2/6/84).

Some foreign governments and business associations are also taking actions which can be expected to negatively affect Florida's future economic climate, particularly in the area of foreign investment. The Japanese Federation of Economic

Organizations (Keidanren) has said that Japanese corporations will stop making investments in states that have adopted the unitary tax system. (Miami Herald, 2/2/84).

The Minister for Financial Affairs of the Japanese Embassy, The Honorable Makoto Utsumi, testified before the Commission that the use of unitary taxation will discourage Japanese investments in Florida. He cited a specific example of a manufacturing site selection decision in which unitary taxation was a deciding factor. He also alluded to the perception problem in a second example:

"A friend of mine in an affiliate Japanese insurance corporation in the United States told me that he had given up his plans to purchase land for the site of a new building for lease, simply because that state had adopted the unitary tax system. When I told him that there would be no unitary taxation if he engaged in only the leasing of the real estate, he replied to me that he also got the same explanation from the state tax authority but he cancelled his plans because he had great uncertainty about the future." (Testimony, 1/18/84).

Bernor E. E. Trost, Trade Commissioner of the Swedish Trade Office, wrote to the Commission, stating that:

"[T]he U.S. is the biggest single area for direct investment -- 28% of all investments made by Swedish companies during 1978-1982 outside of Sweden were directed to the U.S.... A good number of the companies whom we serve have however subsidiaries internationally. I look upon it as our duty

to inform them about the Unitary Tax System and its possible effect." (Letter, 1/12/84).

In a press release dated December 1, 1983, the British Government reiterated its long-standing objections to the method of unitary taxation. The release stated that:

"As long as the worldwide unitary method persists, it will be impossible to achieve the essential economic objectives of providing a consistent and coherent tax framework for international trade and investment. Moreover, the damage to international trade and investment would be greatly increased if foreign government responded by imposing retaliatory measures or introducing unitary systems of their own." (Press release, 12/1/83).

Robert Paul, an international law attorney who heads up the South Florida Initiative's economic development missions to Europe, indicated that damage has already been done to Florida's business reputation. Even if SB 3-C is repealed immediately, he believes that it will be some time before the momentum builds back up again and the confidence of European investors in Florida is re-established. Mr. Paul related specific examples of adverse reactions to Florida's new law expressed by bankers in Rome, manufacturers in Versailles, France, and businessmen in Zurich, Switzerland. He suggested that, if the State's intention was to stop international development, the passage of SB 3-C has already proven to be an effective means of doing so. (Testimony, 2/27/84). He reported that tax dollars are not the

issue for European businessmen and bankers, but the unacceptable disclosure of their business data.

These domestic and international reactions indicate a strong likelihood that future investments in the State will be substantially reduced if the tax provisions of SB 3-C remain in effect. This impact is not limited to new investments, but also will relate to the expansion of and/or reinvestment in existing Florida operations. This potential impact was addressed by Monsanto:

"The management of our corporation has many options when it decides which of the Monsanto plants will be picked to install a new process or produce a new product and, as a result, increase employment or at least protect existing jobs when obsolete operations are discontinued. There is intense competition among the various Monsanto plants to secure new investment from corporate management, but in the long run, management will invest where there appears to be the best chance for long-term economic success. Small differences in expected manufacturing cost or return on investment can be determining factors. Management's perception of the business climate in the various states where the Company operates obviously is important also.

Since the unitary tax is not a broad based tax, its burden must necessarily fall on a relatively few corporations. Monsanto is one of those few and, consequently, the potential for economic success of investments in Florida is diminished." (Letter from R.R. Crone, Jr., Plant Manager, Monsanto Fiber & Intermediates Co., 1/13/84).

The negative image and consequent damage to Florida's economic climate is being intensified by the fact that none of the other southeastern states, with whom Florida competes most directly on economic development, have a requirement for worldwide unitary reportings. These neighboring states have not given any indication that they will follow Florida's lead in adopting this tax mechanism. Instead, witnesses indicated that many of these competitor states are promising potential industrial clients that they will not adopt unitary reporting.

The proponents of unitary frequently cited the experience of California as evidence of a unitary jurisdiction which has enjoyed tremendous economic growth and development. The opponents, on the other hand, repeatedly pointed out that Florida cannot be compared to California from an economic development sense because California's geographic characteristics are very different from Florida's. The opponents contended that, with the ocean to the west and desert and mountains to the east, a firm wishing to serve the California market, or to interface with Far Eastern markets, has little choice but to locate in California, regardless of tax policy. Ken Cory, California's Controller, acknowledged that, because of California's geographic proximity, they will attract business from Japan no matter what the state's tax policy is. (Testimony, 2/6/84).

The opponents observed that Florida, on the other hand, must compete with a variety of other states to attract firms wishing to serve the southeastern markets. Although Florida has competitive advantages, many of them are matched by the other states. Analysis of site selection process, such as in the Coopers & Lybrand Study, indicates that:

"once a broad region or market area has been selected, State and Local taxes as an aggregate are seriously considered when choosing among specific alternative potential sites." (Executive Summary of Illinois Study, 9/83).

The study's author, Dr. Cooper, concluded in his oral testimony to the Commission that "at the margin, unitary tax policy could be the controlling factor." (Testimony, 2/6/84).

It appears that California, with its geographic advantages and its well-established, stable and diverse economic base, can afford to take economic development risks which Florida cannot afford.

Nonetheless, the Commission received examples which indicate that California does lose economic development as a result of its unitary tax policy, even from Japanese companies. Kyocera International, Inc., the U.S. subsidiary of Kyocera Corporation of Japan, has discontinued its investment program in California and divested two California subsidiaries as a means of reducing its presence in that state. The discontinuance of

the investment plans within California resulted in the loss of approximately 800 new direct jobs. Kasey Hasegawa, President and Chief Operating Officer of Kyocera, wrote that:

"Kyocera has adopted a policy that no manufacturing investment will be made within any state embracing the unfair worldwide approach. We have launched a search for attractive locations for future manufacturing and distribution operations within the United States. Much of the search, especially for manufacturing expansion, has centered in the Southeast. Obviously, many factors enter into a final decision of where to infuse capital to build a plant, create jobs, etc. However, Kyocera eliminated Florida from any consideration as a potential plant site strictly on the basis that Florida adopted the worldwide combination method and thereby created an anti-business environment." (Letter, undated).

Patrick J. Doherty, Controller of Castle and Cooke, wrote of his company's decisions relating to California and Florida:

"The timing of enactment of S.B. 3-C is unfortunate in that we moved a major portion of our fresh foods operation out of California (which applies the worldwide unitary method) to Florida in May and June of 1983. One of the major factors involved in our site selection was Florida's favorable corporate tax climate. Another of the factors involved in our decision to move this operation out of California was California's application of the unitary approach on a worldwide basis. If Florida had enacted S.B. 3-C six months earlier, we might have relocated this operation to a state other than Florida. Prior to 1983 we

employed only two salesmen in Florida for a total payroll of about \$50,000. Subsequent to moving our fresh food operations to Florida, we will employ approximately 125 permanent, full-time people for an estimated annual payroll of \$4,000,000."

"We maintain that any state which applies the worldwide unitary approach is indicating that it does not want economic development by multinational corporations. In fact, the state is indicating such corporations should take their jobs and investment elsewhere."
(Letter, 1/9/84).

Although the direct impacts of the provisions of SB 3-C fall on only a small portion of the corporate community, the Commission received testimony relating to the indirect impacts on other companies as a result of multiplier effects. For instance, John Euart, Executive Vice President of Fairfax Properties, Inc., in Atlanta, discussed the estimated multiplier effects associated with IBM's decision to cancel several projects in the South Florida area.

"The total square footage involved in these cancelled expansion plans for IBM was no less than 400,000 square feet, maybe more. Based on my experience as a developer, these cancellations by IBM translate into the following economic losses for the State of Florida: Nearly 1500 new high-paying IBM jobs were lost; additional property taxes of about \$390,000.00 were lost; construction activity over the year ahead of approximately \$24 million was lost; temporary and permanent jobs that would have been a function of this growth were lost."
(Testimony, 1/18/84).

These multiplier impacts can be expected to extend the economic damage of SB 3-C far beyond the directly affected companies. The strong anti-SB 3-C stance of the Florida Manufacturers' Association also reflects the concerns of multiplier businesses. The Association is composed of 1200 Florida-based companies, employing over 165,000 persons.

COMMISSION CONCLUSIONS:

The Commission's conclusion on this question is similar to that reached by Amos R. McMullian, President of Flowers Industries, Inc., who stated:

"Surely it was not the intention of the Legislature to stifle business development and create a hostile environment for corporations doing business in Florida. Nevertheless, that is exactly the result."
(Letter, 1/13/84).

The Commission has had the opportunity to hear and read large amounts of testimony and analysis on the subject -- data which were not available to legislators when SB 3-C was enacted in July 1983. The Commission believes that, had the Florida legislators had the opportunity to review this wealth of information, they would have reached the same conclusion as this Commission -- that is, that the corporate tax provisions of this bill are doing and will continue to do substantial damage to Florida's economic climate.

Florida will never know exactly what the magnitude of the damage might be -- it is impossible to measure what "would have been". However, a rough estimate of the degree of magnitude of the potential damage can be derived, using the State Department of Commerce figure that the State has enjoyed over \$2 billion a year in new investments in each of the past two years as a result of the Department's activities. Department of Commerce testimony showed that roughly half of the State's industrial development prospects have said that the provisions of SB 3-C would have a negative effect on their siting decisions. Therefore, approximately \$1 billion per year in direct investment -- with all of its positive multiplier effects -- may be jeopardized by the passage of this law. Sony's "\$95 wise/\$1 billion foolish" analogy, unfortunately, turns out to be extremely appropriate. The Commission concludes that maintaining the new tax provisions creates a risk which the State can ill afford to assume.

GOVERNOR'S QUESTION FOUR:WHAT ARE THE COMPLIANCE AND ADMINISTRATIVE
REQUIREMENTS OF THE UNITARY TAX?COMMISSION FINDINGS:

There are compliance and administrative implications both for affected companies and for the State. Gerald Goldberg, Executive Director of the California Franchise Tax Board, testified that for U.S. companies, only a "miniscule" amount of additional data has to be prepared in order to file a unitary return. He did acknowledge, however, that the problems may be more severe for foreign-based companies, and that California is considering bills which would provide some administrative remedy for unique problems of compliance. (Testimony, 2/6/84).

The Commission received extensive testimony from affected companies indicating that there are substantial and costly taxpayer compliance burdens which are unique to and inherent in a worldwide unitary tax system. In filing or auditing a combined report, the initial inquiry involves determining whether a group of affiliated corporations is in a unitary business. The code defines a "unitary business group" as a "group of taxpayers related through common ownership whose business activities are integrated with, are dependent upon, or contribute to a flow of value among the members of the group. When direct or indirect ownership or control is 50 percent or

more of the outstanding voting stock, the group shall be considered to be a 'unitary business group' unless clearly shown by the facts and circumstances of the individual case to be a non-unitary business group. When direct or indirect ownership or control is less than 50 percent of the outstanding voting stock, all elements of the business activities shall be considered in determining whether the group qualifies as a 'unitary business group.'" (Section 220.01(1)(aa), Florida Statutes).

Because Florida's definition of a unitary business group is unique, and because a Florida's corporation's activities in Florida is the starting point of evaluation, neither the taxpayer nor the State can rely on unitary determinations which may have been in another unitary state. Additionally, the unitary group determination must be made each year as corporate affiliations change and reorganizations occur. Because of the potentially harsh fiscal impact on a taxpayer if it is deemed to be unitary, testimony indicated that this determination is often contested by taxpayers.

Apart from the determination of the unitary group, preparation of the worldwide combined report itself raises unique problems. The Commission received testimony on a number of such problems, including:

- ** Determining which unitary group's accounting period should be used.

- ** Eliminating allowable intercompany transactions.
- ** Reconstructing accounting records prepared to comply with foreign accounting procedures and tax laws into conformity with U.S. accounting and tax rates. (Most foreign countries do not use G.A.A.P. (Generally Accepted Accounting Principles).)
- ** Bringing records to this State for audit purposes. (This may be impossible if the Florida corporation is a subsidiary of a foreign parent or if an affiliated foreign corporation is subject to a foreign country's confidentiality laws.)
- ** Seeking apportionment factor adjustments to compensate for foreign exchange rate fluctuations.
- ** Converting foreign currencies into U.S. dollars.
- ** Seeking recognition of foreign currency gains and losses.
- ** Adjusting the value of foreign labor into U.S. dollars.
- ** Converting original cost and rent expenses into U.S. dollars for property factor purposes, which first requires resolving the timing and method.
- ** Determining the deductibility of foreign taxes paid on income in the reconstruction process.
- ** Acquiring data about a parent based in a foreign country, data which may only be available from consolidated balance sheets. The net effect of these calculations is to place the foreign corporations on a U.S. reporting, but not Florida income, tax basis.

Since the cost of compliance is so high (some testimony stated that compliance costs can be greater than the tax liability) and since foreign data may be difficult or impossible to compile, worldwide unitary states have at times resorted to imposing the tax on a corporation's worldwide consolidated financial statements. This means that financial statement income is being taxed, as opposed to taxable income determined under tax statutes. (Testimony of Chris E. Gustchenritter, Director of Taxes, Siemens-Allis, Inc., 1/18/84).

Witnesses pointed out that all of these administrative requirements come into effect regardless of the size of a company's Florida operations. For companies with only a relatively small presence in Florida, the costs of compliance may outweigh the benefits derived by being in the State, and operations may be moved as a result.

Siemens-Allis, Inc. provided testimony estimating that it would take four man-years for that company to properly file a unitary return in Florida. They noted such problems as initially communicating the technical requirements of Florida taxation to their personnel in one hundred different languages. For them, the cost can far exceed the actual state tax liability. Siemens concludes that:

"Compliance with the law is so expensive that the tax ends up being arbitrary. That is simply not a fair or just way to implement state taxation." (Testimony, 1/18/84).

The complexities involved in the auditing stages of combined returns are equally as cumbersome. Norman Rusch, State Tax Advisor to Shell Oil Company, discussed questionnaires used by the State of California:

"They started in 1976 and 1977 with some 60 questions for each of the years from 1967 through 1976. We answered those as best we could in 1978, and some we could not answer because the information was not in our hands. Five years later, in November 1983, they sent another onerous questionnaire containing 62 additional questions for the same years. It also contained the comment, and I quote 'Before this inquiry into the issue of unitary is completed, there will undoubtedly be some additional questions that we will need to ask.' That borders on harassment, not fair and equitable taxation." (Testimony, 1/18/84).

The response of foreign companies to the compliance aspects was particularly strong. George Moore, Chairman of the Florida Council of International Development (a private sector advisory board to the Florida government), referenced strong opposition to the use of worldwide unitary taxation from the governments of Great Britain, Japan, Germany and other countries. He characterized Florida's requirements as being "offensive" to foreign companies and their governments. (Testimony, 1/18/84).

Dennis Nason, President of the Florida International Bankers Association, put it a different way:

"Foreign corporations and foreign countries do not reach abroad with their taxes. They

are territorial in nature. This whole U.S. concept of reaching abroad in taxation is alien to them. They don't understand a foreign government doing it, much less a political subdivision reaching abroad to tax foreign income. It is a highly negative, visible profile abroad." (Testimony, 1/18/84).

Robert Paul, Chairman of the South Florida Initiative, a group of business leaders who have made numerous trips to Europe to attract international investment to Florida, called the worldwide unitary tax "deadly". He predicted that, if it is not repealed, the State will have no further development of international trade. He reported that the Europeans are unaccustomed to the exposure of information required in filing a worldwide unitary tax report, and that they don't want anything to do with the concept. But, when asked if they will comply with the new law, he responded that, as responsible businesses, they will either stay in Florida and pay the tax or will make the decision to leave the State completely. (Testimony, 2/17/84).

Additional cost and administrative requirements will surely be experienced by the State as the Department of Revenue (DOR) attempts to administer a new taxation system and to audit returns. Dr. Richard Cooper, author of the 1982 Coopers & Lybrand Study on worldwide unitary taxation for the State of Illinois, testified that Florida "runs a real risk of chaos in early years" because of confusion generated in explaining the new tax laws to taxpayers around the world. The same problems

relating to language and cultural differences, exchange rate fluctuations and differing accounting principles, mentioned above in terms of the companies, will also affect the State's attempts to audit returns.

To be effective, the DOR will have to acquire new expertise to deal with the complexity of the new audit issues. The DOR will either have to develop the capability of auditing financial statement tax returns from virtually every industrialized country and many lesser developed countries around the globe, resort to "financial statement" audits like other unitary states or rely on outside auditors such as the Multistate Tax Commission. The Commission found untenable the suggestion of the Department of Revenue that no new auditors would be needed to administer SB 3-C.

In the past, the State had been able to rely on federal tax audits, and had not attempted to conduct Section 482 audits as an audit tool. (Testimony of Jim Barger, Chief, Bureau of Audit Selection, Department of Revenue, 1/4/84). It appears unrealistic to assume that thorough audits of unitary returns will be more effective or simpler to conduct.

California, which has been in the unitary audit business since the 1930's, spends significant dollars to enforce its unitary tax. In 1982, California spent \$13.3 million on bank and corporate auditing and enforcement activities. Although the \$13.3 million produced increased assessments, a significant amount of revenue is tied-up in administrative

appeals and litigation. (California Franchise Tax Board, Operations Report for fiscal year ended January 30, 1982). Ken Cory indicated that there had been arbitrary and capricious audit determinations and "over-reaching" in California audits in the past. He also reported that these inequities had subsequently been eliminated by changes in their auditing staff personnel. (Testimony, 2/6/84).

In addition, it appears likely that the State will be faced with litigation on a number of issues. Kenneth Claussen, Chairman-elect of the International Law Section of the Florida Bar, testified to the Commission that, although the Container decision found the unitary concept to be constitutionally permissible for unitary business groups with domestic parents, the Supreme Court has not yet resolved the foreign-parent issue. He explained that:

"Prior to the Container decision, the foreign parent issue had been raised by foreign parent corporations in at least three Federal Court proceedings dealing with California's worldwide unitary concept. However, attempts to obtain a speedy and efficient resolution to the issue have been thwarted by procedural barriers. Consequently, if Container is a reliable model - it dealt with assessments made in 1969 for the 1963 tax year, the issue may remain unresolved for a number of years." (Testimony, 2/17/84).

Affected companies reported administrative proceedings and litigation with unitary states which has spanned decades. Norman Rusch, State Tax Advisor to Shell Oil, testified that his company has unresolved tax years back to 1967 in California.

(Testimony, 1/18/84). Dallas Hurston, Assistant Treasurer of the Coca-Cola Company, indicated that Coca-Cola's worldwide combination issue is unresolved back to 1967 in California and back to 1966 in Oregon. (Testimony, 1/18/84). Companies do not pay contested taxes while in the administrative appeals process (often years), but must pay taxes (under protest) before they can go to court. At that point, the entire corporate income tax liability is paid under protest and not available for use by the state -- not just the contested portion.

Tax and budget administration for the State will also be affected by the uncertainties associated with revenues from these new tax provisions. Because of the administrative difficulties and potential legal challenges discussed above, it appears likely that the State will generate little, if any, additional revenues from these new tax provisions in early years. Eugene Corrigan, Executive Director of the Multistate Tax Commission, a group strongly supportive of the use of worldwide unitary taxation, testified that the State cannot expect to receive significant unitary tax revenues for the first several years of implementation. (Testimony, 1/18/84). Moreover, Dr. Cooper, author of the Illinois study on worldwide combined reporting, related that the experience of other states indicates that the taxpayers who benefit from the unitary method -- Florida corporations whose unitary group members are not as profitable as the Florida member (estimated to be 15-20 percent of total affected taxpayers) -- will promptly file and

pay their lower taxes and, in some cases, seek refunds. Dr. Cooper suggested that Florida "should not look at unitary to raise revenue in the short run." (Testimony, 2/6/84).

The uncertainties are further complicated by the means in which the original estimates of the tax revenues were generated. The \$95 million estimate for Florida was derived from a rough extrapolation of revenue estimates for the State of California. (Testimony of B. Zuna, Director, Research, Planning and Budgeting, Department of Revenue, 1/4/84). Many witnesses questioned the means by which the estimate was generated, and Ken Cory admitted that California's \$500 million estimate of the impact of worldwide unitary could be "\$200 million dollars off, one way or the other." (Testimony, 2/6/84). Therefore, it appears likely that Florida's \$95 million estimate may have substantial error in it.

DOR was similarly unable to provide the Commission with reliable estimates of the dollar impact of the individual components of SB 3-C. Throughout the Commission's deliberations, efforts continued to refine the estimates associated with each of the components -- and with the bill as a whole -- but reliable estimates were still not available at the conclusion of the proceedings.

The Department of Revenue told the Commission that the strength of Florida's economy in the past was shown by the mere flattening, not lowering, of revenues from its corporate income

tax during the recent national and international recession.

(Testimony of Zuna, 1/4/84). The Ad Hoc Group queried:

"Won't that stability disappear with a unitary tax that links Florida to the economic vicissitudes of the rest of the world? (i.e., if Florida's corporate income tax revenues were relatively inelastic when insulated from foreign forces, won't worldwide unitary introduce unwanted and unpredictable elasticity?)" (Testimony, 1/18/84).

COMMISSION CONCLUSIONS:

Arthur England, who served as special tax counsel to the Florida House of Representatives in 1971 and 1972, summed up many of the administrative and compliance aspects in his commentary on SB 3-C:

"The three principal concepts of the 1971 enactment -- Florida's first entry into serious corporate taxation -- were to be an ease of compliance by businessmen, a so-called "piggyback" of federal income taxation, and a minimum of administration by Florida's Department of Revenue. All three objectives were not only met but written as guidelines into the Code itself. As a result of these conceptual underpinnings and the unique openness of Florida's legislative process, Florida's income tax law has enjoyed a nationwide reputation as the most progressive piece of tax legislation in the country: significant in its dollar burdens, but reasonable in its compliance and administrative requirements. All three of the framework concepts written into the 1971 Code are undone by the new enactment." (Commentary on Senate Bill 3-C, Arthur J. England, Jr., Esq., July 1983).

The Commission concludes that both affected companies and the State will experience substantial increases in the cost

and effort required to comply with the new tax provisions. These additional public and private sector burdens appear unjustified.

Administrative and compliance problems and complaints appear to be particularly acute in relation to foreign-based companies, and future international trade and investment is likely to be curtailed as a result.

Finally, the probable delays and uncertainties in the amounts of revenues from the tax changes indicate that worldwide unitary taxation is not an appropriate taxing policy for Florida, particularly because the revenue sought to be generated by unitary tax was intended to be collected immediately for 1983-84 fiscal year State programs. This Commission was charged with the task of evaluating the ability of the unitary tax method to supply present revenue for public services, specifically education. The Commission's fact-finding process has revealed that a worldwide unitary tax system will not be a reliable source for the revenue presently budgeted and required for these public services.

GOVERNOR'S QUESTION FIVE:

WHAT HAS BEEN THE EXPERIENCE
OF THE DOZEN OTHER STATES SUCH AS
CALIFORNIA, MINNESOTA, MASSACHUSETTS,
UTAH -- WHICH HAVE LIVED WITH THIS TAX LONGER?

COMMISSION FINDINGS:

At present there are five states which have full worldwide unitary taxation (California, Oregon, Idaho, North Dakota and Florida). Seven other states have some level of worldwide unitary statutes, although two states are not actively applying them. (See Appendix H).

Most of the discussion on the topic centers around the experience of California, which has used the concept since 1937. The California law provided the model for SB 3-C. Ken Cory, California's Controller, and Gerald Goldberg, Executive Director of the California Franchise Tax Board, testified on behalf of California's experience. They believe that worldwide unitary is the fairest means of taxation, both for taxpayers and for states, and that it would be very problematical for California to go back to the separate accounting method. (Testimony, 2/6/84).

California officials believe that worldwide unitary is necessary to capture income which taxpayers otherwise immunize from state taxation. California went to a unitary system as a result of abuses found in the motion picture industry. (Profits were all being attributed to out-of-state distribution

companies, rather than to the in-state production companies.) California officials also indicated that the California business community does not seem to object to the use of worldwide unitary, as they are now fully accustomed to it.

California officials Cory and Goldberg did indicate there is some rethinking of the concept within the state. Cory acknowledged that some audit decisions in the past may have been arbitrary and capricious. Goldberg indicated that there are bills pending which address compliance problems, particularly for foreign-based companies.

California Governor Deukmejian has appointed a study commission, and a variety of bills and resolutions are being considered by the California Legislature. Controller Cory is supporting the Alquist/Johnson bill, which would exempt new businesses from the unitary requirement for five years. Cory explained to the Commission that his support for this bill does not indicate any wavering in his support for the unitary accounting principle, but rather is an attempt to have meaningful dialogue with the corporate community on unitary. Other recently introduced California bills would substantially modify or completely abolish the use of unitary.

The Commission received extensive testimony from affected companies, including California companies, indicating that the California system is not an accepted model, and that substantial problems do exist. Many of these comments have

already been covered in other sections of this report, and include:

- ** Open, unresolved tax issues going back nearly 20 years.
- ** Arbitrary determinations of what constitutes a unitary group.
- ** Charges of double taxation and overallocation of profits to California.
- ** Extensive administrative and court challenges, many spanning decades.
- ** California's use of financial statement income as a proxy for taxable income.

Also mentioned in a prior section was the uncertainty of the California revenue estimates which provided the basis for Florida's estimates.

The Commission found much evidence to suggest that, regardless of what the California experience has been, it is not appropriate to use California as a model for Florida tax policy. Of particular note are geographic and economic differences. Many witnesses pointed out that, if a company wants to serve the California markets and to take advantage of the access to Far Eastern markets, there really is no alternative but to locate within California.

On the other hand, businesses wanting to locate in the southeast can choose from a number of states, many of which have non-unitary tax policies, right-to-work provisions, and other

factors which make them attractive as business locations. Other southeastern states are not following Florida's lead in adopting this type of taxation. The Governor of Georgia is capitalizing on Florida's new competitive disadvantage by publicly stating that Georgia will not adopt unitary taxation. (The Atlantic Constitution, Article, "Governor won't seek a unitary tax system", 10/25/83, p. 1-C).

Florida has not historically had a diversified, stable economic base, and the State has worked aggressively in recent years to stimulate new economic development in manufacturing and other non-traditional (for Florida) industries. California has a stable, diversified economic base which has been developed over many decades, and also has a well established infrastructure -- particularly in terms of universities -- to attract industry. Florida does not share this economic diversification and technological sophistication, and therefore cannot take the same risks that California can in maintaining a tax mechanism which is an economic disincentive for multinationals.

New York State originally applied worldwide unitary tax to all industries. It then limited worldwide combined reporting to the petroleum industry. An analysis of New York's unitary tax as imposed on petroleum companies, prepared by The Public Policy Institute of New York State, December, 1982, reported that New York State has yet to collect any revenues from worldwide unitary taxation of oil companies and that the state

definitely lost jobs through relocation of offices of major oil companies, specifically Mobil, from New York to a neighboring state. Another study, conducted by the New York Department of Taxation and Finance, dealt with the possibility of New York State joining the Multistate Tax Commission (MTC), which would involve adoption of MTC principles, unitary taxation and the Uniform Division of Income for Tax Purposes Act (UDITPA). The report concluded:

- ** Adoption of these principles would reverse the State's pro-business policies.
- ** Adoption of these principles would be a detriment to the business/economic climate of New York.
- ** Competitive state tax structures do have an impact on business location decisions.

("The Multistate Tax Commission: Should New York State Join?", State of New York Department of Taxation and Finance, June, 1983).

New York has now totally repealed worldwide unitary taxation. In his message to the Legislature on February 4, 1984, New York Governor Mario M. Cuomo stated:

"During the past several months, we have seen a growing awareness of the problems created by worldwide unitary taxation. I believe unitary taxation would be a serious

impediment to New York's continued growth as a center of international business. In effect, it would be counterproductive, discouraging the proliferation of private-sector jobs which must be the backbone of our economy. We must reaffirm to the world economic community that New York will not pursue this form of taxation."

Minnesota recently enacted domestic combined reporting and projected \$63 million in revenue for the first year. One witness before our Commission testified that the Minnesota Finance Department has now reduced the impact of the domestic combination in their budget for the coming biennium to zero, and Governor Perpich has asked for its repeal, saying it brings the State more grief than it's worth. (Testimony of Norman Rusch, 1/18/84).

Illinois retreated from worldwide combined reporting and adopted a "water's edge" approach to combination in 1982. At the same time the definition of what constitutes a unitary business was severely restricted by statute to apply only to businesses united by common ownership, in the same line of business, functionally integrated. Illinois Governor James R. Thompson explained why Illinois found it necessary to repeal its worldwide combined reporting statute:

"I sought a tax policy which was straight-forward and could remain consistent over time, and which would fairly and equitably tax corporations with activity in Illinois while at the same time encouraging continued economic growth in this state.

... After study, I concluded that worldwide combination is at odds with current federal tax policy, and it requires a complex and cumbersome conversion process from foreign currencies and foreign accounting procedures. All of these factors led many to conclude that worldwide combination discouraged foreign investment in Illinois and could be a disincentive to economic development statewide. I agree with that conclusion." (Letter from Governor Thompson, 11/5/82 (included in the Fact Book, presented on behalf of an Ad Hoc Group of corporate taxpayers, 11/2/83)).

The Coopers & Lybrand Study done for Illinois, mentioned earlier in this report, similarly concluded that worldwide combined reporting was antithetical to Illinois' economic development.

New Mexico passed a bill in early 1983 repealing the state's statutory authority to tax foreign firms on a worldwide basis. The state never used its worldwide unitary statute, but repealed it, recognizing that just the state's authority to apply the tax was acting as a deterrent for foreign investment.

COMMISSION CONCLUSIONS:

The Commission concludes that, although the experience of other states has been somewhat mixed, there are clear indications of administrative problems and negative impacts on economic development. Since Florida's new laws now incorporate the most far-reaching provisions of any state in the taxation of worldwide income, Florida can realistically expect to experience many of the same problems as these other states.

Moreover, the Commission concludes that it is not appropriate for Florida to attempt to follow the model of any other state in determining state tax policy. Florida must consider its own unique characteristics and its own economic development goals and strategies. Florida must adopt and implement an appropriate tax policy based on these factors, and not rely upon the mixed experience of other states.

The Commission concludes that worldwide unitary taxation principles and the full taxation of foreign source income are not appropriate ingredients for Florida's tax policy.

GOVERNOR'S QUESTION SIX:

IF THE CONCLUSION OF YOUR REVIEW INDICATES THAT A
CHANGE OR MODIFICATION OF THE UNITARY TAX LAW IS NEEDED,
WHAT IS THE CORPORATE-BASED REPLACEMENT REVENUE SOURCE?

COMMISSION FINDINGS

The Commission heard extensive testimony over the course of its investigation regarding the amount of revenue expected to be generated by SB 3-C. The figure of \$95,000,00 was represented as being the annual return from the statute, but the reliability of that number was less than persuasive.

For one thing, the \$95,000,000 annual revenue estimate was derived by extrapolation from California's estimated annual intake of \$500,000,000. That figure was found to be highly suspect, however. California Controller Ken Cory testified that the \$500,000,000 figure was correct, give or take 40%. (Testimony, 2/6/84). California officials further testified that a commission has been appointed by the Governor of California to verify the amount of revenue received in California from the worldwide unitary method of taxation, but that a figure would not be available for some months. Other testimony suggested that the \$500,000,000 figure from California, upon which Florida officials relied to project Florida's revenue from a similar tax, did not represent actual current collections but rather departmental assessments. (Letter from Kyocera International, Inc., undated). Some of

this revenue may never be collected, and other, if collected at all, may be (and has been) deferred for significant periods of time.

A second problem concerning Florida's estimated receipt of \$95,000,000 in fiscal year 1983-84 -- the likelihood that receipts would be far less in fact -- came to light from the experience of other states, from actual collection figures presented by the Department of Revenue, and through the testimony of Eugene Corrigan, the Executive Director of the Multistate Tax Commission.

As mentioned earlier, Minnesota, Illinois, New Mexico and New York experienced a shortfall of revenue, or none at all, after enacting a unitary tax system. Each state has moved either to repeal the law or curtail its operation. Significantly, each suffered financial deficiencies as a result of adopting a worldwide unitary tax system.

The experience of these states was corroborated by officials from the Department of Revenue. Receipts from corporate income tax payments are running well below the estimated \$95,000,000 level, but it is impossible to determine the cause. DOR officials have received only estimated tax returns, but report that corporate income tax revenue returns are coming in \$12.6 million or so under projection. (Testimony of Zingale, 2/6/84). These returns do not indicate whether business activity has dropped, whether estimated returns are being filed on a unitary basis or not, or whether foreign losses

are being combined with domestic gains. Full returns are not currently due, but even those returns may not provide an answer to the causes of the shortfall in revenue collections. Corporations favored by a unitary combination have probably filed their returns early in order to obtain refunds.

According to industry sources, to some extent a lag in collections results from complexities in compiling a return which complies with the new tax statute, and initial selectivity in determining what constitutes a unitary tax business for Florida purposes. Mr. Corrigan, who strongly supports the use of unitary taxation, stated that it will be two or three years before Florida will begin to generate the incremental revenues which might be expected from a unitary tax. (Testimony, 1/18/84).

In sum, it is far from clear that Florida will collect 95,000,000 additional dollars from its corporate income tax in fiscal year 1983-84, or soon thereafter. Nor is it possible for DOR to determine, apparently, how much of that total would come from each of the component parts of SB 3-C. (Testimony of Zuna, 1/4/84).

Nonetheless, all testimony before the Commission indicated full support for educational funding and the need to assure replacement revenues for programs already enacted into law. State officials reported that revenues collected to date from other sources in the current fiscal year appear to exceed

budgeted expenditures, so that the full \$95,000,000 may not be needed from corporate income taxes.

In order to best analyze replacement revenue sources, the chairman appointed a subcommittee to study alternate revenue sources, chaired by Commissioner Drake. The subcommittee held a public hearing in Tallahassee on February 13, at which it received significant input from and had extensive dialogue with members of the audience, including officials of the Departments of Revenue and State. In its deliberations, the subcommittee considered as criteria that the alternative revenue sources should:

- (1) be broad-based;
- (2) come from the corporate sector;
- (3) remain stable with Florida's economy as it develops, so as to grow with the State and not be vulnerable to worldwide cycles and uncertainties;
- (4) be predictable and reliable;
- (5) be compatible with Florida's economic development plan and overall tax policy;
- (6) be consistent with Florida's tax structure as dictated by Florida's Constitution (which essentially requires Florida to depend on non-stable revenue sources, such as corporate tax revenues, which can be affected by recessions and other marketplace fluctuations (Testimony of Jim Zingale, 2/6/84)); and
- (7) be politically acceptable to the Legislature and to the business community.

Using these criteria, the subcommittee evaluated a variety of revenue sources, and brought its recommendations to the full Commission on February 17. There the package of alternatives was re-evaluated, and a range of alternative taxes and fees were again discussed.

Among the alternative sources considered by the subcommittee were the following:

(1) Repeal the corporate income tax provisions of SB 3-C, but adopt new provisions to tax foreign source income at a rate not greater than that of neighboring Sunbelt states (except Texas, which has no corporate income tax). The provisions would specifically enable Florida to tax as corporate income all income except that classified under Sections 861, 862, and 863 of the Internal Revenue Code (the passive foreign source income), thus taxing in Florida the income from export sales; except that Florida would further exempt from taxation the income generated from export sales (sales to foreign, non-U.S. buyers) of products manufactured in Florida, as an additional incentive, over and above that in any neighboring Sunbelt state, for firms to bring their production facilities to Florida.

The estimated tax revenue from all export sales is \$41 million. The exemption for Florida manufactured

products will reduce this revenue by approximately \$1 to \$2 million, according to Dr. Fresen of Planning and Budgeting. (Testimony, 2/17/84).

The subcommittee recommended this as an acceptable funding alternative.

(2) Increase the annual corporate filing fee from \$10 to \$50. D. W. McKinnon, Director of the Florida Division of Corporations, reported that Florida presently has about 300,000 filings annually. (Testimony to subcommittee, 2/13/84). Mr. McKinnon also noted that the number of filers thus far in 1984 exceeds significantly the number to this point last year. These filing fees are relatively inelastic at these levels, and below those of other states. Accordingly, the increase to \$50 will not have a suppressing effect on annual filings, and increasing volumes may actually result in a significant addition to the amount estimated. An increase to \$100 was rejected because of the hardship on small corporations, even though an increase to that level was not perceived as affecting the number of filers. An increase of the annual corporate filing fees to \$50 would generate approximately \$13 million.

The subcommittee recommended this as an accepted funding alternative.

(3) Eliminate the current sales tax exemptions for computer software and services. A predominant portion of these sales are made to the business community, and the Commission heard testimony that this tax is presently being collected on many software sales in any event. Taxing these transactions under Chapter 212 would generate approximately \$30 million annually.

The subcommittee recommended this as an acceptable funding alternative.

(4) Increase the present 5 percent rate applicable to corporate net income. It is estimated that a one percent levy on corporate net income has a value of \$81.9 million, (Florida Tax Sources-Fiscal Impact of Potential Changes, 1983-84, prepared by staffs of the Senate Finance, Taxation and Claims Committee and the House Finance and Taxation Committee, p.3). Thus, based upon this estimate, an increase of 1/2 percent could generate approximately \$40.5 million. Under the Florida Constitution, a rate change must be authorized by a three-fifths (3/5) vote of the membership of each house of the Legislature. A 10 percent education surtax would raise the same revenue but avoid the super-majority vote.

This alternative was rejected as being politically unrealistic.

(5) An increase in annual filing fees for professionals (occupational licenses for lawyers, medical doctors, accountants and others). Such a levy would arguably come from a broadly-based, corporate sector source. However, a number of legal difficulties exist with the concept, as a consequence of which the Commission declined to recommend an increase in professional filing fees as a possible alternative source of revenue. No attempt was made to estimate revenue which might be realized from such increase.

(6) A franchise tax on net worth (capital stock, retained earnings and paid in surplus) to be comparable to the tax levied in Georgia. Some twenty states impose this type of tax, which can have an annual minimum and maximum for each corporation. Georgia has a graduated scale of taxes, with a maximum tax of \$5,000 computed on corporations having a net worth of \$22 million or more. Revenue from a tax in Florida comparable to Georgia's is estimated to be \$35 million per year, according to Dr. Karen Walby of the Governor's Office.

Although the subcommittee found this to be an acceptable funding alternative, and it attracted no apparent opposition from the corporate community, the full Commission declined to recommend this tax at this time.

COMMISSION CONCLUSIONS:

In order to repair the perception problems now plaguing the State and to regain the economic development momentum which existed prior to July 1983, the Commission recommends the following:

1. Amend Chapter 83-349, Laws of Florida, to revise Florida's corporate income tax law to restore the federal tax base and separate accounting method of taxation utilized in Florida prior to the enactment of SB 3-C, and to eliminate the throw-back of sales provision and the distinction between business and non-business income.

This action is necessary principally to signal the end of Florida's flirtation with unitary taxation, worldwide or domestic.

All testimony received by the Commission indicated that little (if any) revenue will be derived from the throw-back provisions of SB 3-C, from the unitary method of reporting in and of itself, or from the allocation of non-business income to Florida. These features of SB 3-C interact with and are inseparable from the taxation of foreign source income. Moreover, there was testimony to the alternatives subcommittee that the throw-back provisions are counter-productive in Florida, which already double weighs the sales factor in its apportionment formula, and would actually penalize in-state producers who have been induced to Florida by the low payroll and property factor weights.

2. Implement a Tax on Export Sales (other than
Florida manufactured products).

The Commission concluded unanimously that there should be no attempt to tax foreign source income which is in the form of dividends, interest, rents, royalties or other so-called "passive" sources. However, there was unanimous agreement that foreign source income resulting from export sales should be included in the taxable base.

Florida is the only state in the Sunbelt which, prior to SB 3-C, exempted such income from taxation. Thus, it appears that the State would suffer no competitive disadvantage by taxing such income. The general perception was that the exemption was, when enacted in 1971, a concession to economic development which has now become unnecessary and undesirable.

Inasmuch as it is State policy to encourage firms to manufacture in Florida, the Commission recommends an exclusion of the export sales for products manufactured in Florida.

Several examples of the impact of the Commission's recommendations on the calculation of the corporate income tax liability of hypothetical corporations are contained in Appendix I of this report.

Estimated revenue: \$40 million.

3. Increase the annual corporate filing fee from \$10
to \$50.

Estimated revenue: \$13 million.

4. Eliminate the current sales tax exemption for computer software and services.

Estimated revenue: \$30 million.

Under these recommendations, all requirements relating to the unitary method of apportionment on both a domestic and worldwide basis will be eliminated, and the State will re-establish the use of separate accounting. The throw-back rule will be eliminated, as will the distinction between business and non-business income.

The Commission's deliberations revealed that, prior to SB 3-C, Florida had, by far, the most generous provisions in the country with respect to the taxation of foreign source income. While it was not within the scope of this Commission to recommend changes in the State's economic development strategy, the Commission concluded that the State's economic development efforts would not be seriously affected by some lessening of these foreign source income exemptions.

With respect to foreign source income as defined by the U.S. government, the new provisions recommended above enable Florida to remain competitive with neighboring states (Alabama, Georgia, Kentucky, Mississippi, South Carolina and Tennessee), each of which provide either full or partial exemptions for Section 861, 862 and 863 income. Each taxes export sales in full.

The recommendations still provide Florida with an economic development incentive not matched by any other state.

The income earned on the export sales of products manufactured in Florida will be exempt from taxation, as it was prior to SB 3-C. However, the income generated by Florida taxpayers on export sales of products not manufactured in Florida will become subject to normal apportionment and taxation. This will serve as further incentive for corporations to bring their manufacturing operations into the State of Florida.

These recommendations will enable the State to generate revenues which are approximately equal to the \$95 million which was appropriated in the 1983-84 budget year as a result of the passage of SB 3-C. It is the Commission's conclusion that these corporate-based alternate revenue sources will provide a much more predictable and stable revenue flow to the State than the SB 3-C corporate tax provisions, and will therefore enhance the State's ability to finance critical public services, in particular, educational improvements.

5. COMMISSION CONCLUSIONS AND RECOMMENDATIONSCOMMISSION CONCLUSIONS:

The Commission unanimously agreed that the State of Florida has taken an action which has generated a tremendous amount of publicity and controversy.

As indicated in the findings for each of the six questions, the facts relating to each issue were not always available, and may never be known in some instances. Good estimates of the dollar impacts of the individual components, and hence the revenue which the State can expect to receive, were not available. The full economic development losses which the State will incur as a result of this controversy will not be felt for many years, and, even then, it will be impossible to determine what "would have been".

Fairness and equity depend heavily upon the perspective from which one approaches the issue. Although affected companies provided convincing testimony of inequities, double taxation and administrative burdens, proponents of the unitary method of apportionment defend it as the fairest method for the states to use in determining taxable income.

The experience of other states is mixed, and in any case, the Commission concludes that Florida cannot follow the model of any other state but must, instead, determine its own economic development and tax strategies.

What did become very clear in the Commission's deliberations is that a situation has been created which is not in the long-term best interest of the State. The relative importance of the facts themselves has receded, and the perceptions of inequity, lack of concern for the State's business community, and instability and unpredictability in the State's tax policy have moved to the forefront. The method of passage of SB 3-C has also been subject to extensive criticism.

Right or wrong, these perceptions become reality if they are used as factors in economic development decisions. Within six months of the passage of SB 3-C, it is clear that this is happening in Florida. Not only have major investments been put on hold or cancelled, but Department of Commerce testimony clearly reveals that the State's new tax policy is a major negative factor with more than half of the State's economic development prospects. Foreign corporations and governments are bitterly opposing the use of worldwide unitary taxation, and the prospects of continued international investment in the State are substantially reduced.

It is the conclusion of this Commission that the State should take action as quickly as possible to eliminate this controversy. Florida cannot afford to risk the loss of major long-term investment opportunities, with their positive multiplier effects on the economy, for short-term revenues which are relatively low and uncertain in amount.

The Commission agrees that, while some of the damage which has been done since the passage of SB 3-C may be irreparable, most can be reversed. The State has the opportunity to take what is now a major negative factor, and turn it into strong positive action. By moving as quickly as possible to satisfactorily modify the situation, the State has the opportunity to demonstrate its commitment to continued economic development, to acknowledge the importance of and re-establish stability and continuity in the State's tax policy, and to re-establish the good working relationship which existed between the State's government and the business community prior to the passage of SB 3-C.

Florida is unique among the states in that its entire corporate income tax program is relatively new. Many of the issues related to SB 3-C were debated extensively prior to adoption of the Code in 1971, and the State made conscious decisions on each aspect. The effect of various components on the State's economic development strategy and the administrative implications of each were integral parts of that 1971 decision-making process.

It is the State's prerogative at any time to change economic development strategies or tax policies. However, the Commission concludes that any such changes should be done in the context of a thorough review of such policies, which was not the case with SB 3-C.

The testimony received by the Commission did confirm the business community's virtually unanimous support for the education programs funded by SB 3-C. The business community reaffirmed its desire for, and willingness to share in the funding of, education improvements, but clearly indicated that business does not believe that SB 3-C provides a fair and equitable means of obtaining the corporate-based funds.

RECOMMENDED ACTIONS:

In order to repair the perception problems now plaguing the State and to regain the economic development momentum which existed prior to July, 1983, the Commission recommends the following:

- 1) Amend Florida's corporate income tax statute to restore the federal tax base and separate accounting method established in Florida's 1971 corporate income tax code, and to eliminate the throw-back of sales provision and the distinction between business and non-business income.
- 2) Implement new provisions to tax foreign source income at a rate not greater than neighboring Sunbelt states (except Texas, which has no corporate income tax).
 - a. Implement new provisions to enable Florida to tax as corporate income all income except that classified under Sections 861, 862, and 863 of the Internal Revenue Code (the "passive" foreign source income basically consisting of dividends, royalty payments, rents and interest), thus continuing to tax in Florida, as was done for the first time in SB 3-C, the income from export sales.

- b. Implement provisions to exempt from taxation the income generated from export sales (sales to foreign, non-U.S. buyers) of products manufactured in Florida, as an additional incentive, over and above that in any neighboring Sunbelt state, for firms to bring their production facilities to Florida.
- 3) Increase the annual corporate filing fees from \$10 to \$50.
- 4) Eliminate the current sales tax exemption for computer software and services.

Under these recommendations, which are discussed in greater detail in the answer to Question 6 above, all requirements relating to the unitary method of apportionment on both a domestic and worldwide basis will be eliminated, and the State will revert back to the use of separate accounting. The throw-back rule will be eliminated, as will the distinction between business and non-business income.

These recommendations will enable the State to generate revenues which are approximately equal to the \$95 million which was appropriated in the 1983-84 budget year as a result of the passage of SB 3-C. It is the Commission's conclusion that these corporate-based alternate revenue sources will provide a much more predictable and stable revenue flow to the State than the SB 3-C corporate tax provisions, and will therefore enhance the

State's ability to finance critical public services, in particular, educational improvements. Appendix J of this report contains a proposed bill which implements the recommendations of the Commission.

It is the hope of this Commission that the Governor and Legislature will accept and support these recommendations, and enact legislation to implement them as early as possible in the 1984 Legislative Session.

LAWS OF FLORIDA

CHAPTER 83-349

Senate Bill No. 3-C

An act relating to taxation; amending s. 214.71(3)(a), Florida Statutes, relating to determination of the base upon which the corporate income tax is apportioned; providing conditions under which sales of tangible personal property are in this state; amending s. 220.03(1)(t), Florida Statutes, 1982 Supplement, and adding paragraphs (aa) and (bb); redefining "state" to include foreign countries; defining "unitary business group" and "nonbusiness income"; amending s. 220.13(1)(b), Florida Statutes, 1982 Supplement; disallowing specified deductions and changing provisions for subtracting certain amounts from taxable income in determining adjusted federal income; amending subsection (1) of s. 220.131, Florida Statutes, to conform provisions relating to affiliated groups; creating s. 220.135, Florida Statutes, providing that all members of a unitary business group must use the unitary reporting method, and providing requirements with respect thereto; amending s. 220.14(3), Florida Statutes; providing that only one exemption shall be allowed to a unitary business group or taxpayers filing a return; amending s. 220.15(3) and (4), Florida Statutes; redefining "everywhere" as used in computation of apportionment factor denominators; deleting provisions relating to a refund under specified circumstances; creating s. 220.16, Florida Statutes, relating to the allocation of nonbusiness income; amending s. 220.63(5), Florida Statutes; deleting a cross reference; amending s. 220.64, Florida Statutes, relating to unitary business groups and application to the franchise tax on banks and savings associations; providing for recomputation of estimated tax due by taxpayers whose tax year begins on or after September 1, 1982, to comply with this act; amending s. 563.05, Florida Statutes; increasing the excise tax on malt beverages; amending s. 563.07, Florida Statutes; reducing the beer distributors' collection credit; amending s. 564.06(1), (3) and (7), Florida Statutes; increasing the excise tax on certain beverages and wines and reducing the distributors' allowance; amending s. 565.12(1), Florida Statutes; increasing the excise tax on certain alcoholic beverages; amending s. 565.13, Florida Statutes; reducing the distributors' allowance; requiring manufacturers, distributors and vendors to inventory beverages subject to the increased taxes and pay the amount of tax due; providing for application of penalty and interest provisions; repealing s. 196.033, Florida Statutes, and s. 236.25(2)(b), Florida Statutes, 1982 Supplement; eliminating the School District Homestead Trust Fund; providing an appropriation to the Department of Revenue for establishment of a corporate income tax historical computer data base and computerized audit

2321

system; providing conditions; amending s. 193.1142(1), Florida Statutes, 1982 Supplement, relating to the date by which ad valorem tax assessment rolls are to be submitted to the Department of Revenue; declaring invalid an emergency rule of the Department of Revenue; making certain changes to the notice of proposed property taxes; amending subsection (1) of section 220.12, Florida Statutes; providing for inclusion of certain nonbusiness income in the calculation of net income; providing an appropriation for the administration of this act; providing effective dates.

Be It Enacted by the Legislature of the State of Florida:

Section 1. Paragraph (a) of subsection (3) of section 214.71, Florida Statutes, is amended to read:

214.71 Apportionment; general method.--Except as otherwise provided in ss. 214.72 and 214.73, the base upon which any tax made applicable to this chapter shall be apportioned shall be determined by multiplying same by a fraction the numerator of which is the sum of the property factor, the payroll factor, and the sales factor and the denominator of which is 3. In the event any of the factors described in subsections (1), (2), or (3) has a denominator which is zero or is determined by the department to be insignificant, the denominator of the apportionment fraction shall be reduced by the number of such factors.

(3) The sales factor is a fraction the numerator of which is the total sales of the taxpayer in this state during the taxable year or period and the denominator of which is the total sales of the taxpayer everywhere during the taxable year or period.

(a)1. Sales of tangible personal property are in this state if the property is delivered or shipped to a purchaser within this state, regardless of the f.o.b. point, or other conditions of the sale or ultimate destination of the property; or if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state, and either the purchaser is the United States Government or the taxpayer is not subject to a tax upon or measured by income in the state to which the sale would be assigned absent this paragraph.

2. When citrus fruit is delivered by a cooperative for a grower-member, by a grower-member to a cooperative, or by a grower-participant to a Florida processor, the sales factor for such growers for such citrus fruit delivered to such processor shall be the same as the sales factor for the most recent taxable year of that processor. That sales factor, expressed only as a percentage and not in terms of the dollar volume of sales, so as to protect the confidentiality of the sales of the processor, shall be furnished on the request of such a grower promptly after it has been determined for that taxable year.

3. Reimbursement of expenses under an agency contract between a cooperative, a grower-member of a cooperative, or a grower and a processor will not be deemed a sale within this state.

Section 2. Paragraph (t) of subsection (1) of section 220.03, Florida Statutes, 1982 Supplement, is amended, and paragraphs (aa) and (bb) are added to said subsection to read:

220.03 Definitions.--

(1) **SPECIFIC TERMS.**--When used in this code, and when not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the following terms shall have the following meanings:

(t) "State," when applied to a jurisdiction other than Florida, means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country, or any political subdivision of any of the foregoing.

(aa) "Unitary business group" means a group of taxpayers related through common ownership whose business activities are integrated with, are dependent upon, or contribute to a flow of value among members of the group. When direct or indirect ownership or control is 50 percent or more of the outstanding voting stock, the group shall be considered to be a "unitary business group" unless clearly shown by the facts and circumstances of the individual case to be a non-unitary business group. When direct or indirect ownership or control is less than 50 percent of the outstanding voting stock, all elements of the business activities shall be considered in determining whether the group qualifies as a "unitary business group."

(bb) "Nonbusiness income" means rents and royalties from real or tangible personal property, capital gains, interest, dividends, and patent and copyright royalties, to the extent that they do not arise from transactions and activity in the regular course of the taxpayer's trade or business. It does not include income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Section 3. Paragraph (b) of subsection (1) of section 220.13, Florida Statutes, 1982 Supplement, is amended to read:

220.13 "Adjusted federal income" defined.--

(1) "Adjusted federal income" means an amount equal to the taxpayer's taxable income as defined in subsection (2), or such taxable income of more than one taxpayer as provided in s. 220.131, for the taxable year, adjusted as follows:

(b) Subtractions.--

1. In computing the net operating loss deduction allowable for federal income tax purposes under s. 172 of the Internal Revenue Code for the taxable year, the net capital loss allowable for federal income tax purposes under s. 1212 of the Internal Revenue Code for the taxable year, the excess charitable contribution deduction allowable for federal income tax purposes under s. 170(d)(2) of the Internal Revenue Code for the taxable year, and the excess contributions deductions allowable for federal income tax purposes under s. 404 of the Internal Revenue Code for the taxable year, there shall be subtracted from taxable income, in order to arrive at adjusted federal income, such amounts as reflect the following limitations:

a. No deduction shall be allowed for net operating losses, net capital losses, and excess contribution deductions under ss. 170(d)(2) and 404 of the Internal Revenue Code which are carried forward from taxable years ending prior to January 1, 1972; and

b. The net operating loss, net capital loss, and excess contributions deductions under ss. 170(d)(2) and 404 of the Internal Revenue Code, respectively, allowable for any taxable year beginning before and ending after January 1, 1972, shall be limited to an amount which bears the same ratio to the taxpayer's net operating loss, net capital loss, and excess contributions deductions under ss. 170(d)(2) and 404 of the Internal Revenue Code, respectively, for the entire taxable year as the number of days in such year after December 31, 1971, bears to the total number of days in such year, unless the taxpayer elects to account separately for income under s. 220.12(3) of this code, in which case the net operating loss, net capital loss, and excess contributions deductions under ss. 170(d)(2) and 404 of the Internal Revenue Code, respectively, allowable for such year shall be determined on the basis of the items actually earned, received, paid, incurred, or accrued after December 31, 1971; and

c. A net operating loss and a capital loss shall never be carried back as a deduction to a prior taxable year, but all deductions attributable to such losses shall be deemed net operating loss carryovers and capital loss carryovers, respectively, and treated in the same manner, to the same extent, and for the same time periods as are prescribed for such carryovers in ss. 172 and 1212, respectively, of the Internal Revenue Code.

d. No deduction shall be allowed for net operating losses, net capital losses, or excess contribution deductions under ss. 170(d)(2), 172, 1212, and 404 of the Internal Revenue Code for a non-United States member of a unitary business group.

2. There shall be subtracted from such taxable income any amount included therein by a member of a unitary business group which was received as a dividend paid by another member of the same unitary business group.

a- Under s- 76 or s- 951 of the Internal Revenue Code;

b- Which was derived from sales outside the United States; and from sources outside the United States as interest; as a royalty; or as compensation for technical or other services; and

c- Which was received as a dividend from a corporation which neither transacts any substantial portion of its business in the United States nor regularly maintains any substantial portion of its assets within the United States.

However, as to any amount subtracted under this subparagraph, there shall be added to such taxable income all expenses deducted on the taxpayer's return for the taxable year which are attributable directly or indirectly to such subtracted amount.

3. In computing "adjusted federal income" for taxable years beginning after December 31, 1976, there shall be allowed as a deduction the amount of wages and salaries paid or incurred within this state for the taxable year for which no deduction is allowed

pursuant to s. 280C of the Internal Revenue Code (relating to credit for employment of certain new employees).

4. There shall be subtracted from such taxable income any amount of nonbusiness income included therein.

Section 4. Subsection (1) of section 220.131, Florida Statutes, is amended to read:

220.131 Adjusted federal income; affiliated groups.--

(1) Subject to subsection (5), any corporation subject to tax under this code, except members of a unitary business group, which is the parent company of an affiliated group of corporations may elect, not later than the due date for filing its return for the taxable year, including any extensions thereof, to consolidate its taxable income with that of all other members of the group subject to tax under this code and to return such consolidated taxable income hereunder, in which case all such other members must consent thereto in such manner as the department may by regulation prescribe. Any Florida parent company of an affiliated group of corporations which is not a member of a unitary business group may elect to consolidate its taxable income with all other members of the affiliated group, even though some of its members are not subject to tax under this code, provided:

(a) Each member of the group consents to such filing by specific written authorization at the time the consolidated return is filed;

(b) The affiliated group so filing under this code has filed a consolidated return for federal income tax purposes for the same taxable year; and

(c) The affiliated group so filing under this code is composed of the identical component members as have consolidated their taxable incomes in said federal return.

Section 5. Section 220.135, Florida Statutes, is created to read:

220.135 Unitary business groups; special requirements.--

(1) All members of a unitary business group must use the unitary reporting method. Under the unitary reporting method:

(a) Adjusted federal income for purposes of s. 220.12 shall mean the sum of adjusted federal income for all members of the group determined for a concurrent taxable year;

(b) The denominators of the apportionment factors shall be calculated for all members of the unitary business group combined;

(c) The general apportionment method shall be used for all members of the group, unless an alternate method is determined to be more appropriate by the department; and

(d) Sales made between members of the group shall be eliminated in the computation of the sales factor pursuant to part IV of chapter 214.

(2) Members of a unitary business group may elect to file a single combined tax return and pay the entire tax due for all taxpayers included in the group.

(3) Adjusted federal income for non-United States members of a unitary business group shall be net income as determined through the use of accounting systems and procedures designed to fulfill the requirements of generally accepted accounting principals (GAAP) adjusted as follows:

(a) Adjustments required to determine taxable income as defined in s. 63 of the Internal Revenue Code and properly reportable for federal income tax purposes; and

(b) Adjustments as provided in s. 220.13(1).

(4) The Department of Revenue shall have responsibility and authority to develop and promulgate rules for reporting requirements of unitary business groups.

Section 6. Subsection (3) of section 220.14, Florida Statutes, is amended to read:

220.14 Exemption.--

(3) Only one exemption shall be allowed to a unitary business group or to taxpayers filing a consolidated return under this code.

Section 7. Subsections (3) and (4) of section 220.15, Florida Statutes, are amended to read:

220.15 Apportionment of adjusted federal income.--Adjusted federal income as defined in s. 220.13 shall be apportioned to this state in accordance with part IV of chapter 214, and for the purpose of applying said part to this code:

(3) The term "everywhere" in part IV of chapter 214, which is used in the computation of apportionment factor denominators, shall mean "in all states of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country, or any political subdivision of the foregoing"; and

(4) In lieu of the equally weighted three-factor apportionment fraction based on property, payroll, and sales which is described in s. 214.71, there shall be used for purposes of the tax imposed by this code an apportionment fraction composed of a sales factor representing 50 percent of the fraction, a property factor representing 25 percent of this fraction, and a payroll factor representing 25 percent of the fraction. However, upon application in accordance with paragraph (a), any taxpayer shall be entitled to a refund of tax, in an amount determined under paragraph (b), if it can establish that the aggregate amount of its net income subject to tax under this code and in all other states for the taxable year exceeds 100 percent of the taxpayer's taxable income, as determined for federal income tax purposes, for the taxable year.

(a) Any taxpayer eligible for a refund under this subsection shall make application therefor in accordance with procedures set forth in part I of chapter 214. All applications for refund under this subsection shall be accompanied by a copy of the taxpayer's

federal income tax return for the taxable year; copies of every return filed by the taxpayer in the states in which it has conducted business for the taxable year; and verification in the form of canceled checks or other receipts of the taxpayer's payments of the amounts shown to be due on the several returns filed with the refund application.

(b) The refund to which any taxpayer shall be entitled under this subsection shall be equal to 5 percent of the lesser of-

1- The excess of the amount subject to tax for the taxable year under this code over the amount which would have been subject to tax if the taxpayer had computed net income for purposes of this code on the basis of the apportionment fraction described in s. 214-71, or

2- The excess of the aggregate amount of net income subject to tax in Florida and in all other states for the taxable year over the amount of federal taxable income for the taxable year.

(c) For purposes of this subsection, the terms "net income subject to tax" and "amount subject to tax" shall mean the amount against which a rate or rates are applied in determining the taxpayer's dealer liability for tax in any jurisdiction.

Section 8. Section 220.16, Florida Statutes, is created to read:

220.16 Allocation of nonbusiness income.--Nonbusiness income shall be allocated as follows:

(1)(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state:

1. If and to the extent that the property is utilized in this state; or

2. In their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the income year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the income year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is deemed to be utilized in the state in which the property was located at the time the rental or royalty payor obtained possession.

(2)(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if:

1. The property had a situs in this state at the time of the sale; or

2. The taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

(3) Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

(4)(a) Patent and copyright royalties are allocable to this state:

1. If and to the extent that the patent or copyright is utilized by the payor in this state; or

2. If and to the extent that the patent or copyright is utilized by the payor in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

Section 9. Subsection (5) of section 220.63, Florida Statutes, is amended to read:

220.63 Franchise tax imposed on banks and savings associations.--

(5) There shall be allowed as a deduction from adjusted federal income, to the extent not deductible in determining federal taxable income or subtracted pursuant to s. 220-13(1)(b)2, the eligible net income of an international banking facility determined as follows:

(a) The "eligible net income of an international banking facility" is the amount remaining after subtracting from the eligible gross income the applicable expenses.

(b) "Eligible gross income" is the gross income derived by an international banking facility from:

1. Making, arranging for, placing, or servicing loans to foreign persons, provided, however, that in the case of a foreign person which is an individual, a foreign branch of a domestic corporation (other than a bank or savings association), or a foreign corporation

or a foreign partnership which is 80 percent or more owned or controlled, either directly or indirectly, by one or more domestic corporations (other than banks or savings associations), domestic partnerships, or resident individuals, substantially all the proceeds of the loan are for use outside the United States;

2. Making or placing deposits with foreign persons which are banks or savings associations or foreign branches of banks or savings associations, including foreign subsidiaries or foreign branches of the taxpayer, or with other international banking facilities; or

3. Entering into foreign exchange trading or hedging transactions in connection with the activities described in this paragraph.

However, "eligible gross income" does not include any amount derived by an international banking facility from making, arranging for, placing, or servicing loans or making or placing deposits if the loan or deposit of funds is secured by mortgage, deed of trust, or other lien upon real property located in the state.

(c) "Applicable expenses" are any expenses or other deductions attributable, directly or indirectly, to the eligible gross income described in paragraph (b).

Section 10. Section 220.64, Florida Statutes, is amended to read:

220.64 Adoption of parts III-VI.--To the extent not manifestly incompatible with the provisions of this part, parts I and III-VI of this code and ss. 220.12, 220.13, 220.135, and 220.16 shall apply to the franchise tax imposed by this part. Under rules prescribed in s. 220.131, a consolidated return may be filed by any affiliated group of corporations composed of one or more banks or savings associations, its or their Florida parent corporation, and any nonbank or nonsavings subsidiaries of said parent.

Section 11. Each corporate taxpayer whose tax year begins on or after September 1, 1982, shall be required to recompute the estimated tax due for such taxable year and shall make the appropriate adjustments, if any, to the remaining estimated payments to insure full compliance with the applicable provisions of this act. Notwithstanding the provisions of s. 220.34, Florida Statutes, estimated tax payments based upon the facts shown on the return for, and the law applicable to, the preceding taxable year shall be recomputed as though the provisions of this act were applicable in said preceding taxable year. No penalty or interest shall be applied to the next estimated tax payment due within 30 days of the effective date of this act for a period of 30 days from the due date.

Section 12. Section 563.05, Florida Statutes, is amended to read:

563.05 Excise taxes on malt beverages.--As to malt beverages containing more than 1 percent of alcohol by weight, there shall be paid by all manufacturers, distributors, and vendors, as herein defined, a tax of 48 40 cents per gallon upon all such beverages in bulk or in kegs or barrels, and, when sold in containers of less than 1 gallon, the tax shall be 6 5 cents on each pint or fraction thereof in said container. However, the excise taxes required to be paid by this section upon malt beverages containing alcohol of not more than 3.2 percent by weight shall not be required to be paid upon such beverages when the same are sold to post exchanges, ship service

stores, and base exchanges located in military, naval, or air force reservations within this state.

Section 13. Section 563.07, Florida Statutes, is amended to read:

563.07 Beer distributors' collection credit.--For the purpose of allowing credit to licensed distributors of malt beverages or beer for the keeping of prescribed records, furnishing bond, properly accounting for and remitting taxes due to the state, such licensed distributors shall be allowed 2.5 ~~3~~ percent of the amount of the tax due, accounted for and remitted to the division, in the form of a deduction from such remittance. However, no allowance shall be granted or permitted when the tax is delinquent at the time of payment.

Section 14. Subsections (1), (3), and (7) of section 564.06, Florida Statutes, are amended to read:

564.06 Excise taxes on wines and beverages; exemptions.--

(1) As to beverages including wines, except natural sparkling wines and malt beverages, containing more than 1 percent alcohol by weight and less than 14 percent alcohol by weight, there shall be paid by all manufacturers and distributors a tax at the rate of \$2.25 ~~\$2.75~~ per gallon.

(3) As to all wines, except natural sparkling wines containing 14 percent or more alcohol by weight, there shall be paid by manufacturers and distributors a tax at the rate of \$1.62 ~~\$2.43~~ per gallon, except that this tax shall not be required to be paid upon all wines manufactured in Florida from fresh fruits, berries, or grapes grown in Florida and not from concentrates thereof, except concentrates of fruits, berries, or grapes grown and concentrated in this state, bottled within this state, and containing 14 percent or more of alcohol by weight.

(7) Every distributor selling wine within the state shall pay the tax to the division monthly on or before the 10th day of the following month, less 1.9 ~~2.4~~ percent of the tax due, which shall be withheld by the distributor for the keeping of prescribed records, furnishing bond, and properly accounting for and remitting taxes due to the state. However, no allowance shall be granted or permitted when the tax is delinquent at the time of payment.

Section 15. Subsection (1) of section 565.12, Florida Statutes, is amended to read:

565.12 Excise tax on liquors and beverages.--

(1)(a) As to beverages containing 14 percent or more of alcohol by weight and not more than 48 percent of alcohol by weight, except wines, there shall be paid by all manufacturers, distributors and vendors a tax at the rate of \$6.50 ~~\$4.75~~ per gallon.

(b) As to all such beverages manufactured and bottled in Florida from Florida-grown citrus products, citrus byproducts, honey, fresh fruits, berries, grapes, sugarcane, guavas, potatoes, peaches, papayas, strawberries, and mangoes, and not from concentrates thereof, except concentrates grown and concentrated in the state, the tax imposed by paragraph (a) shall not apply. However, in lieu

thereof there shall be paid by all manufacturers and distributors a tax at the rate of \$4.15 ~~\$2.39~~ per gallon.

Section 16. Section 565.13, Florida Statutes, is amended to read:

565.13 Monthly payment of tax by distributor.--Every distributor selling spirituous beverages within the state shall pay the tax to the division monthly on or before the tenth day of the following month, less 1.0 ~~1-4~~ percent of the tax due, which shall be withheld by the distributor for the keeping of prescribed records; furnishing bond, and properly accounting for and remitting taxes due to the state. However, no allowance shall be granted or permitted when the tax is delinquent at the time of payment.

Section 17. On the effective date of this section, before opening for business, each vendor in this state shall take an inventory of those alcoholic beverages in inventory upon which the increase in tax imposed by this act has not been paid and shall certify the amount of such inventory to the Division of Alcoholic Beverages and Tobacco on or before September 10, 1983, accompanied by a check or money order for the amount of increased tax. The provisions of chapters 563, 564, and 565, Florida Statutes, relating to penalties and interest for delinquent payment, shall apply to the additional tax levied by this section.

Section 18. Section 196.033, Florida Statutes, and paragraph (b) of subsection (2) of section 236.25, Florida Statutes, 1982 Supplement, created as paragraph (d) of said subsection by chapter 80-381, Laws of Florida, and amended by chapter 82-154, Laws of Florida, are hereby repealed.

Section 19. There is hereby appropriated \$300,000 from the General Revenue Fund to the Department of Revenue for the establishment of a corporate income tax historical computer data base and a computerized audit system. The Department of Revenue shall provide the Legislature with a plan and schedule of activities for development and implementation of the data base and audit system by September 1, 1983, and shall periodically provide progress reports in connection with requests for said release and expenditure of funds. Specifications for the data base and audit system shall be developed in consultation with the Senate Committee on Finance, Taxation and Claims and the House Committee on Finance and Taxation. If the Speaker of the House and President of the Senate object in writing, the money shall not be spent unless the Administration Commission approves the expenditure by two-thirds affirmative vote of the members present with the Governor voting in the affirmative. Absent such affirmative vote the money shall not be spent.

Section 20. Subsection (1) of section 193.1142, Florida Statutes, 1982 Supplement, is amended to read:

193.1142 Approval of assessment rolls.--

(1) Each assessment roll shall be submitted to the executive director of the Department of Revenue for review in the manner and form prescribed by the department on or before the first Monday in July 1. The roll submitted to the department need not contain centrally assessed properties prior to approval under this subsection and subsection (2). Such review by the executive director shall be made to determine if the rolls meet all the appropriate requirements of law relating to form and just value. Upon approval of the rolls

by the executive director, the hearings required in s. 194.032 may be held.

Section 21. Department of Revenue emergency rule 12-ER-83-4 is hereby declared to be invalid and void.

Section 22. Notwithstanding the provisions of s. 200.069(3) and (4), Florida Statutes, all operating levies of school districts shall be contained on a single line of the notice of proposed property taxes. This line shall be the one entitled "Public Schools" in the first column. The lines title "By State Law" and "By Local Board" in the first column shall be stricken through. The amounts listed in the second, third and fifth columns shall be the sum of the school district levy required pursuant to s. 236.02(6), Florida Statutes, and other operating school district levies. This section shall apply only to taxes levied on the 1983 tax roll.

Section 23. Subsection (1) of section 220.12, Florida Statutes, is amended to read:

220.12 Net income defined.--

(1) For purposes of this code, a taxpayer's net income for a taxable year which commences on or after January 1, 1972, shall be that share of its adjusted federal income for such year which is apportioned to this state under s. 220.15 plus nonbusiness income allocated to this state pursuant to s. 220.16, less the exemption allowed by s. 220.14.

Section 24. Amendments to sections of the Florida Statutes enacted by this act shall not operate to repeal or otherwise negate amendments to the same sections which may have been enacted at the 1983 Regular or Special Sessions of the Florida Legislature and which are not indicated herein, and full effect shall be given to each, if that is possible. If provisions of this act are in direct conflict with amendments enacted at the 1983 Regular or Special Sessions of the Legislature, the provisions of this act shall control.

Section 25. There is hereby appropriated to the Department of Revenue from the General Revenue Fund the sum of \$200,000 for fiscal year 1983-84. The department is hereby authorized to establish 23 new full-time positions for the purpose of administering the provisions of this act.

Section 26. This act shall take effect upon becoming a law, provided that:

(1) The provisions of sections 1 through 11 and section 23 shall apply retroactively to taxable years beginning on or after September 1, 1982.

(2) Sections 12 through 17 shall take effect September 1, 1983.

Approved by the Governor July 19, 1983.

Filed in Office Secretary of State July 19, 1983.

Tax Law Notes

Florida's "New" Unitary Corporate Tax

by Laurel D. Landry and Larry Gragg

Editor's Note: This Tax Law Notes column is a two-part article discussing amendments to the Florida Corporate Income Tax Code passed by the 1983 Florida Legislature. The first part by Laurel Landry, staff attorney for the House Committee on Finance and Taxation, is a synopsis of the bill and how it works. The second part written by Larry Gragg, a practicing attorney, comments on the bill's enactments and its impact on Florida's business.

Part I

In the latest special session of the Florida Legislature, a far-reaching package of bills was passed: an education act,¹ a tax act,² and an appropriations act.³ This package contains important educational reforms, raises the money to pay for those reforms, and appropriates the revenues raised. The tax act contains, inter alia, major changes in the corporate income tax base and increases in the excise tax on certain alcoholic beverages. This article discusses those changes in the corporate income tax base found in Chapter 83-349, Laws of Florida. This discussion is intended to be explanatory rather than political, and the author hopes that it will answer most of the readers' more obvious questions regarding the new law.

A historical perspective may be helpful in understanding this bill. The Governor in his 1983-85 biennial budget recommendations named education as his number one priority. During the regular 1983 session, the House of Representatives passed CS/CS/SB 357, as amended, which contained increases from 5 percent to 7 percent in the corporate income tax rate and from 2 percent to 2.8 percent in the emergency excise tax rate to fund various educational reforms. The Senate refused to concur with the House amendments. Its version of CS/CS/SB 357 contained no such tax increases. A conference committee was named and during the "B" special session, a compromise bill was



adopted which contained no funding source.⁴ The education portion of the appropriations bill, however, was vetoed by Governor Graham on June 30, 1983.

On June 27, 1983, the United States Supreme Court upheld California's worldwide unitary tax in *Container Corporation v. Franchise Tax Board*.⁵ On July 7, 1983, Governor Graham issued the proclamation calling for special session "C."

At the direction of the leadership, similar bills were prepared for both houses by staff of the House Committee on Finance & Taxation, the Senate Committee on Finance, Taxation & Claims, and the Department of Revenue working in cooperation. The Senate bill was ultimately passed by a vote of 29 yeas to 10 nays in the Senate, and 62 yeas and 51 nays in the House. The act was signed by the Governor on July 19, 1983, and became Chapter 83-349, Laws of Florida.

The following paragraphs discuss the specific provisions contained in each section of Chapter 83-349 pertaining to the corporate income tax.

The language in §1 of the law was provided by the Department of Revenue and was designed to adopt the throwback rule and reverse the effect of the decision in

Department of Revenue v. Parlier Banana, 391 So.2d 726 (Fla. 2d DCA 1981). In that case the court held that legislative intent dictated that attribution of sales for purposes of the apportionment formula must be determined by destination of goods. Section 214.7(3)(a) has been amended to provide that sales will be attributed to Florida if (1) the goods are delivered or shipped to a purchaser in Florida, or (2) the goods are shipped from Florida and (a) the purchaser is the U.S. Government, or (b) the taxpayer could not be subjected to an income tax in the state to which the sale would otherwise have been assigned. For example, a Florida seller ships goods to a purchaser in Venezuela. Assuming Venezuela does not subject the seller to an income tax, the sale would be attributed to Florida for apportionment purposes.

Section 2 of the law provides two new definitions and amends one existing definition. The term "state," as used in the Code, has been expanded to include any foreign country or its political subdivision.⁶ The basic definition of a "unitary business group" is a "group of taxpayers related through common ownership whose business activities are integrated with, are dependent upon or contribute to a flow of value among members of the group."⁷ Although this definition provides no litmus test, it follows the standard articulated in *Container Corporation*: "The prerequisite to a constitutionally acceptable finding of unitary business is a flow of value. . . ." ⁸ The provision creates a rebuttable presumption that a group is a unitary business group when there is direct or indirect ownership or control of 50 percent or more of the outstanding stock. When ownership control is less than 50 percent, the burden is on the Department of Revenue to establish whether the group is a unitary business group. The department is directed to examine all elements of the group's business activities in order to make such a determination.

A definition of "nonbusiness income" is provided, creating for the first time a distinction between income earned in the taxpayer's regular course of trade or business and that arising outside the regular course of business. Basically, it includes all income which does not arise from activities that are part of the taxpayer's regular operations. For example, an oil company is in the business of producing and marketing petroleum products. The income earned from sales of its products is obviously earned in its regular trade or business. The company, however, is engaged in a cash flow management program of short term investments. Profits earned from these investments are nonbusiness income.

The distinction between nonbusiness income and income earned in the regular course of business is important because income earned in the regular course of business may be fairly apportioned. Under *ASARCO, Inc. v. Idaho State Tax Commission*,⁹ nonbusiness income, on the other hand, is apportionable only if a unitary relationship exists between the corporation whose securities generate the income and the corporation receiving the income. After *ASARCO*, it appeared that the only nonbusiness income which could be taxed constitutionally by Florida is that which could be allocated to this state because of the corporation's commercial domicile or the situs of the property generating the Florida nonbusiness income. Apportioning the Florida nonbusiness income would have the effect of diluting it. The nonbusiness income which is allocated to Florida is taxed at the full amount; it is not reduced by the ratio provided in the apportionment formula, as is income earned in the regular course of business.

Section 23 of the new law specifies that net income is that share of a taxpayer's adjusted federal income which is apportioned to Florida, plus nonbusiness income allocated to this state. The general rule as provided in §8 of the new law allocates nonbusiness income to the state of the taxpayer's commercial domicile. However, nonbusiness income related to real or tangible property located in this state is to be allocated to Florida.

Section 3 amends the definition of "adjusted federal income."¹⁰ The major change is the repeal of the foreign source income exemption. This section also provides that no deduction will be allowed for any net operating loss carryovers or carrybacks for non-U.S. members of

unitary business groups. Dividend income received by a member of a unitary business group from another member of its group is deducted. Nonbusiness income is also subtracted from taxable income.

Section 4 amends the provisions relating to taxation of affiliated groups which file consolidated returns pursuant to F.S. §220.131 to clarify that members of a unitary business group may not file a consolidated return.

The provisions relating to the reporting method for unitary business groups are contained in §5, which creates a new §220.135. Under the unitary reporting method, a taxpayer which is a member of a unitary business group shall report the group's total adjusted federal income. The denominators of the apportionment factors shall be calculated for the entire group. All members of the group must use the general apportionment method, unless the Department of Revenue determines that an alternate method is more appropriate.¹¹ Intra-group sales are eliminated from the sales factor of the apportionment formula.

Taxable income for non-U.S. members is to be determined using generally accepted principles with the adjustments listed in §63 of the Internal Revenue Code. In essence, non-U.S. members will be required to fill out U.S. federal income tax forms even though federal law may not require this.

The law anticipates that if a unitary business group contains more than one Florida taxpayer, each taxpayer will file separately. Section 5, however, allows the taxpayers to file a single, combined report for all of the Florida taxpayers who are members of the unitary business group. The total tax liability of the group should be the same whether the taxpayers file independently or in combination, but the option is provided for the convenience of the group. Whether the taxpayers file a single, combined report or independent reports, the report filed should contain information relevant to the same time period for all of the group members.

For example, unitary group member A is a Florida taxpayer, and is on a July to June fiscal year. A's return should show information for the group for a July to June period, even though some members of the group are on a different fiscal year. If group member B is also a Florida taxpayer that has a fiscal year different from A's, B and A should agree on which time period to use.

Under F.S. §220.14 a \$5,000 exemption

is granted to all taxpayers. Under the old law, affiliated groups filing a consolidated return must split the exemption between themselves. Now under the new law, unitary business groups are also allowed only one exemption, whether they file independently or on a single, combined return.

The apportionment formula used to determine the Florida corporate income tax is a combination of weighted fractions which compare certain of the taxpayer's Florida activities to the total of those activities "everywhere." The activities measured are sales, payroll, and property. The factors are weighted and then added together to determine what fraction of a taxpayer's adjusted federal income may be apportioned to (and thus taxed by) Florida.

Apportionment Formula =

$$\begin{aligned} & 50\% \frac{(\text{Florida Sales})}{(\text{Total Sales})} \\ & + 25\% \frac{(\text{Florida Payroll})}{(\text{Total Payroll})} \\ & + 25\% \frac{(\text{Florida Property})}{(\text{Total Property})} \end{aligned}$$

Prior to the enactment of this law, only activities relating to the 50 states and the District of Columbia were included. The formula has not changed, but now "everywhere" includes U.S. territories and possessions, Puerto Rico, and any foreign country.¹²

Besides restoring the term "everywhere" to its more common meaning, §7 deletes a refund provision. Under the prior law, a taxpayer was entitled to a refund of the amount by which the aggregate amount of its net taxable income subject to tax in Florida and in all other states exceeded 100 percent. For example, a taxpayer did business only in Florida and Illinois. Florida subjected \$100,000 of its income to tax. Illinois imposed an income tax against \$225,000 of its income. The taxpayer, however, only had a taxable income of \$300,000. The taxpayer could have received a refund of \$25,000 from Florida.

This refund was perhaps appropriate when Florida did not tax foreign source income; but if the provision had remained in effect, Florida revenue would be vulnerable to any overreaching taxation scheme devised by any jurisdiction unrestrained by the due process clause. Although this refund was eliminated, taxpayers may still obtain relief from the Florida apportionment formula, if it is indeed inappropriate.¹³

Sections 9 and 10 of Chapter 83-349 contain conforming amendments to the franchise tax portion of the Code. All financial institutions which are subject to the Florida corporate income tax, including Edge Act Corporations but excluding international banking facilities, must include any foreign source income in adjusted taxable income. Likewise, a Florida bank which is a member of a unitary business group must report using the unitary reporting method.

The general effective date of the Act is July 19, 1983. Sections 1 through 11 and section 23 of the law apply retroactively to taxable years beginning on or after September 1, 1982. For example, a Florida corporation's tax year began on January 1, 1983. The corporation must report and pay its 1983 taxes as if this law came into effect on January 1, in order to provide consistency throughout a taxpayer's tax year.

Taxpayers whose tax year began on or after September 1, 1982, may have already made at least one estimated payment. These taxpayers are required to recompute the remaining estimated payments, if any, and to make any appropriate adjustments.¹⁴ Taxpayers making estimated payments based upon last year's tax base must recompute that information as if this act were in effect during that year. This is required to ensure that the estimated payments reflect the proper tax base.

A 30-day grace period is provided for any taxpayers who had an estimated payment come due within 30 days of the effective date of the act. No penalties or

interest will be applied against an underpaid estimated tax payment during that period for 30 days from the due date of the payment. The purpose for this grace period was to recognize that taxpayers who were required to make estimated payments during that period would probably be handicapped by a lack of general understanding of the act and by delays in availability of updated tax forms and instructions.

In conclusion, Florida has expanded its corporate income tax base for the first time since the tax was enacted in 1971. Under the Florida Constitution, it is easier to change the base than the rate.¹⁵ Many of the details of administration of the changes are left to department rule. The department, however, has much to guide it: the law itself, a series of Supreme Court decisions on the unitary business principle, as well as the experience of the other states which have a similar corporate income tax system. ■

¹⁴SB 2-C, 1983 Special Session "C," by Peterson (similar to HB 7-C, 1983 Special Session); Fla. Laws ch. 83-348.

¹⁵SB 1-C, 1983 Special Session "C," by Johnston (similar to HB 5-C, 1983 Special Session); Fla. Laws ch. 83-349.

¹⁶SB 1-C, 1983 Special Session "C," by Johnston (similar to HB 6-C, 1983 Special Session "C"); Fla. Laws ch. 83-350.

¹⁷SB 38-B, 1983 Special Session "B," by Peterson and others, amended by SB 2-C (Fla. Laws ch. 83-348); (compare with SB 6-B, 1983 Special Session "B").

¹⁸1 U.S.L.W. 4987. For a fuller understanding of the unitary business principle, the reader should study the following line of

cases: *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. ____ (1982); *FW Woolworth Co. v. Taxation and Revenue Dept.*, 458 U.S. ____ (1982); *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980); and *Mobile Oil Corp. v. Comm'r. of Taxes*, 445 U.S. 425 (1980).

¹⁹See FLA STAT §220.03(1), 1982 Supplement, for previous language.

²⁰Fla. Laws ch. 83-349, §2.

²¹51 U.S.L.W. 4987 at 4992.

²²*ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. (1982).

²³See FLA STAT §220.13, 1982 Supplement for previous language.

²⁴But see FLA STAT §214.73.

²⁵Fla. Laws ch. 83-349, §7.

²⁶FLA STAT §214.73 allows alternative apportionment methods to the apportionment formulas provided by the code.

²⁷Fla. Laws ch. 83-349, §11.

²⁸Article VII, §5(b) of the Florida Constitution requires a 3/5 vote of each house to change the rate above five percent. A change in the base only requires a majority vote by a quorum in both houses.

Florida's "New" Unitary Corporate Tax

Part II

The legislature on July 12, 1983, after one day of hearings and workshop sessions enacted SB 3C which made the most broadbased policy amendments to the Florida Corporate Income Tax Code ("Code") since its enactment in 1971. As one legislator has publicly stated the legislation "was rammed through the Legislature with little public comment."¹

The significance of the policy impact of the amendments is best summed up by Arthur J. England, former Florida Supreme Court justice, who as special tax counsel to the Florida House of Representatives in 1971 is regarded as the father of the Code, who stated that the legislation changed the Florida business tax climate "from the most hospitable, fair and accommodating in the country to the most hostile, heavy handed and greedy."²

The purported legal basis for the corporate income tax portions of the legislation was the United States Supreme Court's decision in *Container Corporation of America v. Franchise Tax Board*³ handed down on June 27, 1983.⁴ This also appears to be the reason, i.e., its constitutionality was in doubt prior to this date, that the legislation was not considered in the regular session when it could have received the review that should have been accorded legislation of this magnitude.

This comment will examine the scope of the legislation as it relates to the purported

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legal basis for the legislation which is directly related to the validity of the justification for the abbreviated legislative review. The analysis will show that the relationship of the *Container Corporation* decision to the concepts embodied in SB 3C was misunderstood from inception.

While the amendments made by SB 3C affect multiple provisions, there are essentially the following four separate conceptual amendments: (1) the broadening of Florida's unitary tax concept to multicorporate enterprises including foreign corporations; (2) the inclusion of certain foreign source income in the Florida tax base; (3) the amendment of the sales factor of Florida's apportionment formula to provide for the application of the so-called "throwback rule"; and (4) a second amendment to the sales factor of the apportionment formula which is intended to narrow the pure destination test originally employed in determining the situs of a sale for purposes of the sales factor. Any of these four amendments could have been made without the necessity of making the other three. Each of these conceptual amendments and the legislature's ability to have enacted them without the authority of *Container Corporation* will be examined below.

By way of background it is necessary to understand the issues before the Supreme Court in *Container Corporation*. It is also important to understand what was not at issue in the case. The following three issues were before the Court: (1) Did the taxpayer, a Delaware corporation doing business in California, and its overseas subsidiaries constitute a "unitary business" for purposes of state tax; (2) If the taxpayer and its subsidiaries were a unitary business, did the application of the three-factor apportionment formula fairly apportion the taxpayer's income to California; and (3) Did the application of the unitary tax to the taxpayer and its subsidiaries violate the Foreign Commerce Clause of the United States Constitution?

The Court concluded that the state court had applied the correct standard in determining that the taxpayer and its subsidiaries constituted a unitary business, California's apportionment formula fairly apportioned the unitary businesses' income and the application of the unitary tax to the taxpayer and its foreign subsidiaries did not violate the Foreign Commerce Clause.

With respect to the relationship between the legislature's ability to enact the various corporate tax components of the legis-

lation and the *Container Corporation* decision, there is probably the strongest relationship between the decision and the broadening of the unitary tax principles previously applied in Florida. In order to understand what the legislature could have enacted without the *Container Corporation* decision, one must understand how Florida previously applied the unitary tax concept.

Prior to the enactment of SB 3C, Florida applied unitary tax principles.³ Florida utilized as the tax base the domestic taxable income of each corporate taxpayer, despite the fact that the taxpayer might have several separate functional divisions which were not doing business in Florida, unless the taxpayer could establish that it was entitled to separate accounting treatment. Florida, however, had limited its application of the unitary concept in two significant respects. First, it had not applied the unitary principle to multicorporate enterprises, i.e., if a portion of an otherwise unitary business was conducted in another corporation and that corporation was not doing business in Florida then that corporation's taxable income was not included in determining the tax base of the corporate member of the unitary business which was doing business in Florida. This exclusion applied equally to domestic corporations incorporated in other states and overseas corporations. Florida's other limitation on the unitary tax principle was the exclusion from the tax base of foreign source income of a corporation which was doing business in Florida notwithstanding the fact that the income may have arisen from a unitary business.

In very general terms, the unitary method enacted by SB 3C rejects separate corporate existence in arriving at a particular taxpayer's tax base. Instead, it determines the composition of the unitary business. If this unitary business crosses corporate lines, then despite the fact that a particular corporation part of the unitary business is not doing business in Florida, for purposes of determining the tax base of those members which are doing business in Florida, it includes the taxable income of all members of the unitary business. The tax base thus derived is assigned to Florida in a two-step process. First, certain non-business income is allocated to a particular jurisdiction based on a set of rules, and the balance is apportioned on the basis of the three factor apportionment formula.

It is important to note that the propriety of unitary tax concept per se was not in

question in *Container Corporation*. The unitary method of tax had been sanctioned long before the *Container Corporation* case. In fact, according to a recent Comptroller General Report 39 states, including Florida, employed some form of unitary tax.⁴ The Supreme Court, itself, in *Container Corporation* stated that the "legal principles defining the constitutional limits on the unitary business are well established."⁵

Thus, the legislature could have expanded Florida's unitary tax to include domestic multicorporate enterprises without the authority of *Container Corporation*. Arguably it could not have expanded this to worldwide multicorporate enterprises because of the pendency of the *Container Corporation* case. There were, however, 13 states which had enacted a worldwide unitary tax without such authority.⁶

The second conceptual amendment is the inclusion of certain foreign source income. Although this provision is necessary to effectuate the worldwide multicorporate unitary tax enacted by SB 3C, foreign income of domestic corporations doing business in Florida could probably have been included in the tax base without the authority of *Container Corporation*. It would appear that Florida's exclusion of foreign source income of a domestic corporation doing business in Florida was not constitutionally mandated, but was rather self-imposed because of the difficulty of avoiding a double tax on this income.⁷

In addition to the amendment effectuating the worldwide multicorporate unitary tax and the inclusion of foreign income, there were two amendments to the method of computing the sales factor of the apportionment formula. Both amendments, the enactment of the throwback rule, and the modification of the destination test involve policy issues distinct from the unitary tax issues in *Container Corporation*. Both policy issues had been considered by the legislature when the Code was adopted.⁸ The modification to the destination test is, in fact, a reversal of a judicial interpretation of the Code.⁹

In summary, the only portion of SB 3C which was dependent on the *Container Corporation* decision was the expansion of the unitary tax principle to include in the tax base the taxable income of overseas corporations which are determined to be a part of the unitary business group. The *Container Corporation* case did not serve

as the legal basis for a majority of the changes which were adopted in SB 3C. The issues which were not dependent on *Container Corporation*, which will raise substantial revenues in their own right, should have been considered during the regular session where they could have received the proper legislative and public consideration.

If the decision had been made during the regular session to broaden Florida's unitary tax to include domestic multicorporate enterprises, the desirability of further broadening it to include foreign corporations could have been considered with the ultimate decision to be dependent on the Supreme Court's ruling in *Container Corporation*. It would even have been possible to pass standby legislation on this latter point pending a favorable ruling in *Container Corporation*. ■

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They write this column on behalf of the Tax Section, Henry H. Roatiama, Jr., chairman, and Lauren Deizel and Peter Kirkwood, co-editors.

* Miami Herald, July 27, 1983, at A3, col. 5.
1 Id. at 3 BM, col. 2.

151 U.S.L.W. 4987 (U.S. June 27, 1983).

* Miami Herald, July 8, 1983, A4, col. 2.

1 FAC Rule 12C-1.15(4)(a).

4 COMPTROLLER GENERAL, REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS, KEY ISSUES AFFECTING STATE TAXATION OF MULTIJURISDICTIONAL CORPORATE INCOME NEED RESOLVING, 66 (hereinafter COMPTROLLER GENERAL).

151 U.S.L.W. at 4991-4992.

5 COMPTROLLER GENERAL at 66.

6 An Introduction to Florida Corporate Income Taxation, A. England, BACKGROUND SCOPE AND ANALYSIS 22 (Special Publication of the FLA. STAT. L. REV. 1972); A. England, REPORT TO THE HOUSE ON PROPOSED CORPORATE INCOME TAX LEGISLATION 2-19 - 2-20 (Nov. 3, 1971) (hereinafter REPORT).

7 REPORT at 14-15.

8 Dept. of Revenue v. Parker Banana Co., 391 So.2d 762 (Fla. 2d D.C.A. 1980).



BOB GRAHAM
GOVERNOR

STATE OF FLORIDA
Office of the Governor
THE CAPITOL
TALLAHASSEE 32301

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EMBARGO: This speech is embargoed
for publication and radio and television transmission
until noon, Friday, November 11, 1983.

GRAHAM ANNOUNCES COMMISSION TO STUDY IMPACT OF UNITARY TAX

TALLAHASSEE--Governor Bob Graham today announced he was forming a commission to study the impact of the recently passed "unitary tax" program and that the chairman of the panel would be the Dean of the University of Florida Business School, Robert Lanzilotti.

In a speech prepared for delivery at 12:30 p.m. Friday, November 1983 to the Council of 100 at their Fall meeting in Palm Beach, Graham said, "I am appointing this commission out of a willingness to determine the full impact of the unitary tax and out of a commitment to keep Florida as the one state with America's best climate for business."

The Governor said he would announce the remaining members of the committee within the near future.

"It will be the responsibility of those who oppose the unitary tax to come forward with a plan for replacing the \$95 million in education funds it represents," Graham said.

(MORE) 6-18

ADD ONE

"We are not going to blow a \$95 million hole in our new-found national reputation for education excellence."

Graham told the Council of 100, which is made up of the top chief executive officers of Florida companies, that he was aware that some business was unhappy with the tax.

"I am also aware that for most businesses, the unitary tax has no impact. One business group, Associated Industries of Florida, Inc., says the unitary tax affects only about five percent of Florida corporations.

"It is important to remember where the unitary tax came from. It was a last-minute solution to a legislative problem: Florida needed a revenue source to pay for reforming public education. The revenue sources which I had recommended were unacceptable to the Legislature, because of the lobbying effort made by those who opposed each specific element of my plan.

"Those who made all other revenue sources impossible made the unitary tax inevitable."

The Governor said the following are questions the commission will address:

1. Is the unitary tax fair and equitable to corporate taxpayers?
2. Is the unitary tax compatible with Florida's strategy for economic development?
3. Does the unitary tax have such a negative image that it does damage to Florida's economic climate?
4. What are the compliance and administrative requirements of the unitary tax?

(MORE) 6-19

ADD TWO

5. What has been the experience of the dozen other states -- such as California, Massachusetts, Minnesota, Utah -- which have lived with this tax longer?

6. And finally, what will be the corporate-based replacement for the unitary tax to replace this source of revenues needed for our schools?

A copy of the Governor's remarks is attached.

-30-

GOVERNOR GRAHAM'S REMARKS
TO THE COUNCIL OF 100

It is gratifying to be with the Council of 100 again -- gratifying because of our accomplishments together in the field of public education, and gratifying because of the continued good health of our state's economy.

Housing starts are up, unemployment -- although it rose last month -- remains comfortably below the national average, and we stand to benefit from trends at the national and international levels.

And we have emerged as a national leader in the movement to reform and improve public education.

Last spring I asked for your help to make Florida's public schools better places in which to learn.

With your help, we have established statewide standards for receiving a high school diploma -- standards which the Southern Regional Education Board calls the most rigorous in the Southeast.

We have lengthened the school day, provided scholarships for new mathematics and science teachers, constructed science laboratories and computer workshops.

We have passed legislation to erect a career ladder for teachers, rewarding the best teachers for a job well done through merit pay.

And we have begun to give teachers an economic incentive to remain in the classroom.

With your help, Florida has become a national leader in the movement for educational reform.

The results of these improvements in public education are long-term economic benefits to Florida. A better trained, more adaptable, more intelligently motivated workforce is a key element of our future economy.

And better schools will make our state more attractive to new businesses -- companies which tell us that the quality of our schools is an important factor in their decisions on where to locate.

To achieve these educational benefits and accomplish this leap forward in our economic development program, we have had to increase taxes.

And in the process, we have had to increase the taxes which

you, as business people, pay -- for services like transportation, for providing pure drinking water, for a sound system of public education.

And one of those taxes is very controversial.

This is the so-called "unitary" tax.

I want to make two points unmistakably clear on the unitary tax.

First, I am as willing today as I was in July to study the unitary tax, to review its application in Florida, and to modify it according to our special conditions and special needs.

I am aware that some business people are unhappy with the unitary tax. I am also aware that for most businesses, the unitary tax has no impact.

One business group, Associated Industries of Florida, Inc., says the unitary tax affects only about five percent of Florida's corporations.

For some, it will have the effect of reducing their state corporate taxation.

Second, it's important to remember where the unitary tax came from. It was a last-minute solution to a legislative problem:

Florida needed a revenue source to pay for reforming public education. The revenue sources which I had recommended were unacceptable to the Legislature, because of the lobbying effort made by those who opposed each specific element of my plan.

Those who made all other revenue sources impossible made the unitary tax inevitable.

This provides us with a lesson in how American government really works:

Blind opposition to all forms of new taxes -- in the face of the need for additional revenue for an important public purpose -- is the best way to ensure that you get the tax you least expect, and like the least.

I am today announcing the appointment of a special study commission, appointed by the Governor, Senate President Curtis Peterson, and Speaker of the House Lee Moffitt, to review the effects of the unitary tax.

The members of this commission will be announced in the near

uture. Serving as its chairman will be Robert F. Lanzillotti, dean of the College of Business Administration at the University of Florida.

The work of this commission will dovetail with the work which the Council of 100 is undertaking, to study the implications of the Fantus report five years later.

Your study of how the state responded to concerns about its business climate, and your plan of action for the next five years, will afford us a major opportunity:

An opportunity to review comprehensively, among other elements, state tax policy as it relates to education, transportation, capital facilities, and to the maintenance of our strong economic environment.

The President, the Speaker and I are appointing this commission out a willingness to determine the full impact of the unitary tax, and out of a commitment to keep Florida as the one state with America's best climate for business.

These are some of the questions this commission will address:

1. Is the unitary tax fair and equitable to corporate taxpayers?
2. Is the unitary tax compatible with Florida's strategy for economic development?
3. Does the unitary tax have such a negative image that it does damage to Florida's economic climate?
4. What are the compliance and administrative requirements of the unitary tax?
5. What has been the experience of the dozen other states -- such as California, Massachusetts, Minnesota, Utah -- which have lived with this tax longer?
6. And finally, what will be the corporate-based replacement for the unitary tax to replace this source of revenues needed for our schools?

We are not going to blow a \$95-million hole in our newfound national reputation for educational excellence.

We are not going to relent. We are not going to repeal. And we are not going to retreat.

There can be no retreat in the quest for excellence --

excellence in education, excellence in economic development, excellence in protecting the environment that makes Florida what it is.

But there is another form of retreat, of negativism, that is abroad in our state today.

It is the siren song of lower taxes and less government.

That negativism is packaged under the rhetoric of getting government off our backs, and camouflaged as a positive force.

I am talking about a proposed constitutional amendment that is designed to cripple government's ability to serve you.

Amendment One is designed to roll back taxes, to ask government to start off with a fiscal handicap and never catch up to inflation.

Florida is America's fastest-growing urban state. By the year 1990, we will be the fourth largest state. Ten years later, we will be the third largest.

We will need roads, water and sewers, schools, colleges and universities.

We will require new prisons, new mental health facilities, and be additional personnel to operate them.

This proposed Amendment One will have a broad, disabling impact on our planning for these future needs, and on our ability to meet them.

It refers to a new and ambiguous concept virtually unknown in Florida law -- "taxing units."

It would go beyond cutting taxes to cutting actual revenues, from virtually any source -- student tuitions, landing fees, lease incomes, and more.

It permits no recognition of population growth in America's fastest-growing major state.

And it would have the effect of throttling government's ability to serve people.

Take one example of government service -- providing airports.

Did you know that Amendment One will have an impact on most of the major international airports in Florida?

There will be lawsuits if it should somehow pass. But it appears probable that at least in those counties where the airport is administered as an arm of county government, airport revenues will be subjected to the same throttling as government in general.

Look at what would happen in West Palm Beach, the airport through which many of us just recently passed.

Palm Beach International Airport this fiscal year expects to see just over 3.1-million passengers. In 1980-81 -- the base year for Amendment One -- only 2.5-million passengers came through Palm Beach International.

During that time, Palm Beach International's state and local revenues have increased, from \$8.5 million to \$10 million.

By 1985-86, passengers will increase to 3.4-million, and as the law is now, state and local revenues will hit \$12 million.

But under Amendment One, more than \$1 million of that budget will be wiped out.

What Amendment One wants to do is ask Palm Beach International to cope with nearly a million more passengers, but with a million fewer dollars than it currently projects.

In other words, to deal with a 36 percent increase in passengers while cutting back projected state and local revenues by 9 percent.

This is the projected effect on one element of local government in just the first five years. Imagine the first 10 years -- the first 15.

Imagine living under Amendment One by the year 2000.

Can you run your business like that?

I think not.

The same situation would occur in Miami International, where revenues would drop 27 percent from expected levels;

At Tampa International, with a 31 percent cut;

At Fort Lauderdale-Hollywood International, with a 22 percent cut.

What do you think will happen to these airports if Amendment One becomes part of our constitution?

The airports will curtail investment in new runways. In expansion of terminals, concourses, hangars.

Maintenance will be reduced -- not just on the shrubs and flowerbeds, but maintenance of the runways and terminal buildings which represent a public capital investment.

And because some current revenues must be used to pay back existing bonded obligations, the Amendment One cutbacks will affect other budget categories disproportionately.

This is hard dollars and cents.

The trend line is clear:

Adopt Amendment One, or fail to oppose it vigorously, and you will see a cutback in economic growth.

You will participate in the effects of the decline in services to our growing international business community.

And you will observe in your own balance sheet the impact of Amendment One on tourism -- on the tourists who pay sales taxes -- as our airports deteriorate.

And you will worry about the potential for driving away existing major employers -- such as Eastern Airlines, America's largest airline -- to other, less radical environments.

I say the supporters of Amendment One are flying under false colors.

They proclaim themselves as the supporter of the home owner, the voice of the little guy.

The reality is, they are the radical voice of the privileged few, demanding more tax relief than any of us here in this room today can afford.

You have not heard the last from me on this subject. You will be hearing from me in person, on the telephone, and in small groups.

I need your support. Florida demands your support.

The fact is, Florida has one of the best tax structures in America.

We are running a fiscally conservative operation. We are providing adequate government services at one of the lowest levels of taxation in America.

As long as I am governor, with your help, I intend to fight to keep it that way.

Thank you.

GOVERNOR'S UNITARY TAX STUDY COMMISSION:
SYNOPSIS OF BACKGROUNDS OF THE MEMBERS

Chairman, Dr. Robert F. Lanzillotti, of Gainesville, Dean of College of Business Administration, University of Florida.

W. C. Birchfield, of Jacksonville, Partner with the law firm of Martin, Ade, Birchfield & Johnson and former member of Florida House of Representatives and Florida Constitution Revision Commission.

Dr. Joe Boyd, of Melbourne, Chairman of the Board of Director of Harris Corporation.

Hyatt Brown, of Daytona Beach, Insurance Executive, member of the Board of Regents and former member of the Florida House of Representatives.

J. Clint Brown, of Tampa, Regulated Industries Partner with the law firm of Fowler, White, Gillen, Boggs, Villareal and Banker, P.A.

Paul Cejas, of Miami, Certified Public Accountant, President and Chairman of the Board of Miami Savings and Loan, and Chairman of the Dade County School Board.

John "Jack" Cooney, of Miami, Certified Public Accountant and Tax Partner with Coopers & Lybrand.

Howard Davidson, of Boca Raton, General Manager of IBM Corporation and member of the Governor's Economic Development Council.

Jeff Davidson, of Tampa, Certified Public Accountant and Tax Partner with Deloitte Haskins & Sells and member of the Florida Institute of Certified Public Accountants Committee on State Taxation.

Tine Wayne Davis, of Jacksonville, Vice President of Winn Dixie Stores, Inc.

Fred Drake of Tallahassee, President and Chief Executive Officer of Mobile Industries, Inc. and Chairman of the Florida Council of 100.

Ralph H. Haben, Jr., of Tallahassee, Attorney and former Speaker of the Florida House of Representatives.

Marshall Harris, of Miami, Attorney and former member of the Board of Regents.

Dr. Jerry Hesch, of Miami, Professor of Law, University of Miami Law School, former chief counsel to the IRS and author of articles on taxation.

W. Richard Johnston, of St. Petersburg, Certified Public Accountant and Partner with Ernst and Whinney, member of the Postsecondary Education Planning Commission, and former chairman of St. Petersburg Junior College Board of Trustees.

Burke Kibler, of Lakeland, Partner with the law firm of Holland and Knight and former member of the Board of Regents.

Dr. Mildred W. Ravenell, of Tallahassee, Professor of Law and Associate Dean for Academic Affairs, Florida State University College of Law, and former member of the Board of Business Regulation.

Carol Rist, of Miami, Vice President and Treasurer of Kendall Plastics Corporation, past president of the Dade County League of Women Voters, and immediate past chairwoman of the Florida League of Women Voters Tax Committee.

Renee Ann Wright, of Dunedin, President of Chilton Construction Company.

State tax, funding blueprint reached

By Mark Prendergast
Capital Bureau Chief 7/16/83

TALLAHASSEE — Gov. Bob Graham said today he would call the Legislature into a two-day special session next week to ratify a \$227.8-million educational funding increase proposal with large corporations, alcoholic beverage drinkers and property owners picking up the tab.

Flanked by Senate President Curtis Peterson, D-Lakeland, and House Speaker Lee Moffitt, D-Tampa, Graham said he was optimistic that the Legislature would adopt the complex tax and spending plan when it convenes either Monday or Tuesday.

Although the tentative plan would substantially raise the public school's budget for the 1983-84 fiscal year, Graham said would not accomplish everything he had hoped it would.

"We are asking for our teachers and our students to extend themselves," he said. "We are setting new expectations and new standards and they are not going to be reached casually."

The tentative plan breaks into two major categories: the program to improve the quality of public education in Florida and the means of funding it.

Graham, Moffitt and Peterson have agreed on these tax proposals:

- A \$70.5-million increase in the wholesale alcoholic beverage tax which would amount to 1.5 cents per one-ounce drink of liquor, 1.5 cents per four-ounce drink of wine

Proposals

- Higher school property taxes.
- Hike in alcoholic beverage tax.
- Ending an exemption for foreign profits from corporate income tax.

and 1 cent per can of beer. Officials said this would cost a person \$7.97 a year if he were to buy 13 fifths of liquor, 12 fifths of wine and 37 six-packs of beer. The tax would take effect Sept. 1.

- Removal of the foreign source income tax exemption for multinational corporations. This would raise \$95 million. Under current law, business profits and other income derived from transactions in foreign countries are exempt from taxation in Florida. The U.S. Supreme Court recently upheld the right of states to tax this source of corporate income. Florida is one of only seven that has such an exemption.

- A \$82.3-million increase in property taxes. This would raise the school millage portion of a property tax owners bill from 3.89 mills to 4.4 mills but lower the discretionary millage that school districts can levy from a maximum of 1.6 mills to 1.1 mills. (A mill equals \$1 per \$1,000 of assessed property value.)

The additional money would be used for these program improve-

Please see GRAHAM, 6A

Graham

Continued from page 1A

ments for Florida's schools:

- \$130 million to provide local school districts with enough money to give teachers a 6.5-7 per cent pay raise.

- \$5.5 million to give community college teachers a 3 percent pay raise.

- \$13.3 million to give university teachers a 3 percent pay raise.

- \$31.4 million to allow some school districts to add a seventh period to the school day and to intensify math and science curriculum.

- \$1 million for computer camps

for public school students.

- \$2 million in financial incentives for university students to become certified math and science teachers.

- \$10 million to buy computer equipment for schools.

- \$4.6 million for math and science teacher summer training.

- \$1 million to train principals in evaluating teacher performance.

- \$750,000 for a merit pay council study commission.

- \$7.3 million for quality improvements in community colleges and \$6.7 million for universities.

- \$10 million to purchase

science lab equipment for public schools.

- \$1.5 million to assist rural county school districts.

- \$12.75 million for the state working capital trust fund.

A week ago today, Graham vetoed the bulk of the \$3.6-billion school spending portion of the state budget after stumping the state to criticize lawmakers for inadequately funding education. He left other portions of the budget intact, but also vetoed \$9 million in local projects, known in legislative jargon as "turkeys."

Legislators eye taxes, school bill

Graham signs RAISE bill

6A

By Mark Prendergast

Ft. Lauderdale News

Capital Bureau Chief

7/12/83

TALLAHASSEE — A fragile \$228-million compromise on an educational improvements proposal seemed to be hanging on this morning after a frantic night of negotiations involving House and Senate leaders and Gov. Bob Graham.

Legislators said that they would vote on the package late today as a two-day special session officially got under way at 10 a.m.

One senator said he was so optimistic for passage that he had a plane reservation to leave the capitol at 6:30 this evening.

Major components of the bill would raise \$95 million in new taxes on foreign corporate income, \$62.3 million in higher property taxes, and \$70.5 million in new beer, wine and liquor taxes. The money would be used, in part, to raise teacher salaries and performance, expand math, science and computer courses and phase in longer class days.

The session was made necessary by Gov. Bob Graham's veto of the original public school budget, which he said was inadequate.

One of the major glitches in the agreement involved Dade legislators. Delegation Chairman Ron Silver, D-North Miami Beach, said his colleagues' concerns over adequate school funding for his school district had been resolved during a series of meetings Monday night. He said Dade County would get an additional \$15 million for its public schools. However, there seemed to be some confusion over whether other counties would be allowed to avail themselves of the same formula offered to Dade.

The key element involves the transfer of 0.3 mills of property tax from capital outlays to operating expenses. That, officials said, would give Dade \$15 million. An additional \$2 million would come from a \$10-million infusion in the overall state school budget.

But influential Dade Sen. Jack Gordon, chairman of the Senate Education Committee, said he did not believe that the agreement provided enough money to cover cost-of-living increases for district employees.

House Speaker Lee Moffitt, D-Tampa, said the House "will endeavor to complete our work today." He refused to say how many votes he believes the tax and budget plan has in the 120-member House, but reiterated his belief that it would pass.

Senate proponents said they had

Please see TAXES, 5A

22 "heavily committed" votes, not including four of Dade's seven senators. They said they believe those four — Larry Plummer, Roberta Fox, John Hill, and Carrie Meek — would vote for the plan, giving them 28 votes.

Twenty-one votes are needed in the 40-member Senate.

"I think it will all hang together," said House Speaker Pro Tempore Steve Pajcic, D-Jacksonville. "It will be close, but I think we've got the votes."

At the other end of the spectrum is Holiday Republican Rep. Ron Richmond, the House Republican leader. He said most of his 35 partisan colleagues — and possibly a decisive number of conservative Democrats — were appalled by the tax bill and can be expected to vote against it unless it is changed.

Moreover, big business and the liquor industry mounted a full-scale attack against various aspects of the tax bill while legislators from Dade County, worried their school district would be short-changed, had balked at the distribution of the new school dollars.

Graham met with Dade House members Monday night while across town Senate President Curtis Peterson, D-Lakeland, had a similar session in a private home with Dade senators.

With notable exception of the Council of 100, a Tampa-based business group that announced support for the plan, industry and conservative opposition to the tax plan erupted when representatives got their first full look at the bill Monday morning. Criticism, voiced in committee meetings and private conversations, was as varied as it was intense.

The House version of the tax bill included what were labeled far-reaching and ill-conceived provisions not generally regarded as part of the original proposal worked out by Graham, Peterson and Moffitt last week.

For example, industrial revenue bonds, issued to finance capital improvements, would face a new tax.

"I don't know where that came from," said Charles Reed, Graham's deputy chief of staff and the governor's leading legislative strategist. "We're taking it out."

Rumors, initiated by angry businessmen and their lobbyists, circulated that the proposed tax on foreign profits would amount to \$300 million. Officials supporting the tax package flatly denied that assertion, saying their original \$95-million figure was accurate.

Much confusion was evident among rank-and-file legislators and industry representatives as details of the tax bill emerged.

"Nobody knows what the hell it does," Richmond exclaimed.

Former Chief Supreme Court Justice Arthur England, representing the Miami Chamber of Commerce, told legislators their hasty development of the tax package summarily discards more than a decade of pro-business tax policy. That, in turn, could lead to a reversal of Florida's growing reputation as the "No. 1 Business Climate" in the country and the exodus of numerous businesses, he said.

"Personally, I regret seeing Florida's corporate income tax degraded in this manner," England said.

Fort Lauderdale Republican Rep. Debby Sanderson, whom Broward Delegation Chairman Fred Lipman characterized as the only "no" vote in the delegation, said the bill would drive perhaps 100 financial institutions out of Florida.

"They could move out in a week," she said.

Numerous representatives of multinational corporations, such as Coca-Cola and IBM trooped before legislators to argue the foreign-profits tax and other tax revisions would prove counterproductive. Some even urged a simple hike in the current domestic profits tax as an alternative, a proposal that failed during the regular 60-day session and 20 days of overtime deliberations.

Liquor lobbyists, whose clients face higher taxes at the wholesale level, presented lawmakers with figures showing Florida's liquor industry is far and away the highest-taxed in the nation.

12 State report

20 World report

Fl. Lauderdale News

7-14-83



Legislature '83

Graham: New taxes show commitment to education

By Mark Prendergast

Capital Bureau Chief

TALLAHASSEE — Basking in the glow of one of his most hard-fought legislative triumphs, Gov. Bob Graham said Wednesday a new \$200 million-plus tax on business, property and alcoholic beverages would nourish — not undermine — the state's continued economic growth.

"Companies will come to Florida because they will realize our commitment to education is real," Graham said in a press conference only hours after the Legislature approved the tax-and-spend package for schools in a frantic late night session. "Florida continues to be a very low-tax state."

Graham preferred to stress the educational improvements, such as teacher pay raises, longer class days, more math, science and computer education and an embryonic merit-pay plan, that the tax package will fund, rather than dwell on business' adverse reaction to higher taxes.

"I don't necessarily believe the seventh period (of the school day) will be a lockstep — a clone — of the first six periods," he said, pointing out it is designed to intensify math and science education. "The ultimate test is going to be student performance."

However, the governor took the opportunity to reiterate his opposition to a November 1984 grass roots tax referendum whose leaders earlier in the day publicly deplored the tax increase. Graham said voter approval of the tax-limitation measure would put "shackles" on government.

"What would give impetus to Proposition One (the tax amendment) would be if state government (and) local government failed to meet the needs of the people," Graham said, rebuffing the suggestion this latest tax boost could fuel the fires of the tax initiative.

Business leaders and numerous lawmakers had complained during the special two-day session, which lasted only one hour into the second day, that the business tax was ill-reasoned, hastily drafted and ramrodded through a confused Legislature.

Indeed, many legislators had remarked they couldn't understand the new tax system of "unitary business groups" and its relationship to taxing corporate profits overseas.

When asked if he understood the complex concept, Graham replied he did. When asked if he could explain it, Graham replied he could. When asked if he would, Graham said: later.

After the news conference, the governor consented to offer this explanation: The unitary business group formula treats a parent company and its subsidiaries as a "vertically-integrated entity."

This, in turn, allows Florida to tax foreign profits and "certain intercorporate transactions," both previously exempt from state taxation, Graham said.

The new corporate taxes are officially estimated to raise \$95 million, although business lobbyists contended the figure was closer to \$400 million. An accompanying boost in beer, wine and liquor taxes will raise \$76 million.

However, a \$62.3 million property tax increase was discovered late Tuesday to raise perhaps only about half that much new revenue. The reason: new property tax roll projections were far lower than anticipated.

That means the overall tax increase could be as low as \$203 million or as high as \$233 million.

Graham asserted this was nothing to worry about, especially considering a \$20 million guarantee of emergency school funding from the state's surplus.

The governor also downplayed liquor-industry concern over the tax increase on their products.



The state

Corporate profits tax law signed; industry vows battle to repeal it

Fort Lauderdale News, Wednesday, July 20, 1983

12A

The Associated Press

TALLAHASSEE — Gov. Bob Graham unceremoniously signed into law Tuesday a controversial new corporate profits tax that outraged Florida business leaders say should be repealed.

"Going to court would take too long," said Jon Shebel, president of Associated Industries of Florida, a business lobby. "We want a special session of the Legislature to repeal the tax."

The controversial tax, modeled on California's assessment of corporations' worldwide income, was part of a \$233 million tax-for-schools package (SB 3-C) that Graham signed. He also signed a bill (SB 1-C) that provided \$2.2 billion in general revenue for school projects and authorized about \$1.2 billion statewide in property taxes for schools.

Additionally, Graham signed a bill letting counties collect a special penny sales tax during 1985, if their voters authorize it during the November 1984 general elections, and use the money to build jails, courthouses or other criminal justice facilities.

Last month, the governor vetoed the bulk of a \$3.6 billion public schools budget approved by lawmakers during the 1983 legislative session. Graham said the education portion of lawmakers' no-new-taxes \$11.45 billion budget would retard the state's goal of improving public schools.

On Tuesday, Graham praised lawmakers for writing a new schools bill that "provides the budget support needed to upgrade Florida's elementary and secondary, community colleges and university programs."

The package included new taxes on property, alcoholic beverages and corporations' out-of-state profits. Florida's corporate-tax rate is 5 percent.

Big business fought the \$95 million corporation tax on grounds that it would tarnish Florida's pro-business image.

A recent study by Alexander Grant Co. of Chicago said Florida had the No. 1 business atmosphere in the nation.

"One very hot day in July — July 12 — the Florida Legislature changed the business-tax climate of the state from the most hospitable, fair and accommodating in the country to the most hostile, heavy-handed and greedy," declared Miami tax lawyer Art England, a former Florida chief justice who represents business interests in the tax fight.

Tax on multinationals may cost Florida jobs

For two years now, Florida's Department of Commerce, in its search for new industry, has been happily boasting that the state enjoyed the nation's No. 1 business climate. And with good reason.

Alexander Grant and Co., one of the country's leading accounting firms, bestowed that title as the result of a survey that found Florida leading other states in all sorts of measurable categories — including low taxes.

But I wouldn't hold my breath on Florida keeping that lofty position. The reason is the capricious, ill-timed and highly questionable decision of the Legislature earlier this month when it voted to tax foreign income of corporations doing business in the state.

Schools

The tax is expected to generate \$95 million of the \$233.3 million Gov. Bob Graham says is needed to pay for improvements to the state's public school system.

I certainly have no quarrel with upgrading the state's educational prowess. It's one of the most important steps Florida has taken in recent years. One reason Florida has failed to attract more new industry is the lack of a sound public education system.

But a number of other proposals were advanced during the legislative session that I'm convinced were far sounder — including an increase in the corporate income tax.

These proposals, however, would have left untouched the exemption for the foreign income of multinational companies.

The Legislature obviously took note of this in targeting the multinationals to pay the \$95 million.

It's necessary to understand two points, however.

First and foremost, they have been the conduit for thousands of new jobs Florida might not otherwise have.

Coral Gables is a splendid example. Renowned as a base for companies that want to do business in Latin America, it is home to nearly 100 multinationals. A 1980 study showed they provide more than 3,000 jobs and have a payroll of nearly \$80 million.

Second, most multinationals in Florida don't have to operate from here. They can anchor in a great many other states that don't have what's known as a unitary tax that,

Larry Birger



in effect, allows states to take a corporation's entire international income into account in figuring its state tax bill.

Ray Hagen, general manager of Goodyear Tire's Latin operation in Coral Gables, puts it succinctly: "If 65,000 of our employees in 47 plants in 26 countries are going to be selectively taxed because of an office with 14 employees, obviously that isn't fair, and we will have to move."

In effect, legislators opened the gates for neighboring states like Georgia and Louisiana. Both would love dearly to grab off a large chunk of Florida's foreign trade.

By its precipitous action, the Legislature practically assured that Florida won't enjoy its No. 1 status when the Alexander Grant report is issued next year — and this will undo years of hard work in establishing the state's favorable business atmosphere.

Tom Cox, who is heavily involved in the firm's yearly survey, says as much:

"It [the new law] certainly will be detrimental [for Florida] in trying to attract new industry because it places an extra burden on companies like the multinationals who don't have to bear it by going elsewhere."

'Greedy'

Hagen, who is this year's chairman of Coral Gables' Economic Development Board, is trying to rally support behind an effort to get the unitary tax repealed before it does untold damage.

So, too, is lawyer Arthur England, the former chief justice of the Florida Supreme Court who helped draft the original corporate profits tax. In England's view, the Legislature's action — perhaps unwittingly — changed Florida's business tax climate "from the most hospitable, fair and accommodating in the country to the most hostile, heavy-handed and greedy."

What the Legislature did needs undoing in a hurry.

- 2** Bill Doyle on investing
4 Treasury issues
5 Earnings digest
7 Mutual funds

Fort Lauderdale News

Business

TH Thursday, Aug. 11, 1983

Section D

Targeting corporate tax

Not even legislator who voted for it has anything good to say

By Elizabeth Roberts

It seems nobody has anything good to say about the Florida new corporate income tax package. Legislators who voted for it.

Broward County legislator Peter Deutsch said he did so only because it was in a tax package that would raise \$237 million for education, and he assured about 100 business people at a breakfast Wednesday that "if the parade of horrors turn out to be reality I am sure we will repeal it."

Florida's business leaders have come out strongly against the new law requiring Florida corporations to pay state income tax based on their worldwide earnings instead of on their nationwide profit.

They have started a repeal campaign, and if Wednesday morning's panel discussion was any indication, they should have no problem getting it passed.

Sponsored by the Fort Lauderdale/Broward County Chamber of Commerce, Wednesday's debate turned out to be more of a consensus as officials and businessmen alike blasted the tax as inequitable and a breach of the promise Florida made to businesses. It was the last day of a special session, July 12, when Florida legislators narrowly approved a tax package raising \$237 million — \$95 million from the unitary tax — to upgrade the state's educational system.

The panelists agreed that re-vamping the educational system is a must if Florida is to continue attracting economy-boosting industry, but most favored a 1 percent rise in corporate tax over the unitary tax.

"This is not a question of education; this is a question of fair taxation," said Coleman Travitt, head of the International Center for Florida Taxpayers. "If we are going to force companies to come to Florida if we tell them that they have to pay a tax on worldwide profit even if their Florida firm is losing money."

"Conceptually, they could reach out for the worldwide profits of our Swedish parent company," agreed Parkson Corp. Vice President Robert Pflaier.

Panelist Michael Dixon's Britain-based firm, Simplegrew, moved to Florida two days before the tax law passed. His company considered absorbing its losses and moving, but decided to hold on and cancel plans to move an export division here. The real problem here is that the tax has no sound economic basis, he said.

Florida's reputation as being "business friendly" is being hurt, he said. Steel Hector & Davis, said that by some estimates another part of the tax package, taxing foreign-sourced income, would by itself raise \$95 million the state needs for education.

Retaining that tax and abolishing the unitary tax would solve Florida's appropriation problem and still allow Florida to keep its promise to businesses, he said.

Drive begun to show governor how levy hurts Florida's image

By Larry Lipman
 The Orlando Sentinel

TALLAHASSEE — Executives of the nation's largest companies are being asked to tell Gov. Bob Graham what they think of Florida's new unitary corporate income tax in hopes of showing him the tax will hurt the state's carefully cultivated pro-business image.

The protest campaign is being orchestrated by Associated Industries of Florida, the self-proclaimed "Voice of Business," which is the leading opponent of the \$95-million tax passed by the Legislature last month as part of a \$233-million educational enhancement program.

Jon Shebel, Associated Industries president, said Wednesday that letters are being sent this week to the chief executive officers of the 1,500 largest industrial companies as determined by Fortune magazine. An equal number of letters is being sent to Florida companies with national and international footprints. The letters ask them to tell the governor how they think the tax will affect their decisions on whether to locate or expand in Florida.

In addition, the executives are being asked to send a two- or three-minute videotape to Associated Industries explaining their opposition to the tax. Those tapes will be edited together and copies sent to Graham and the legislative Finance and Taxation committees, Shebel said.

Shebel met with Graham Tuesday afternoon. Graham has steadfastly supported the unitary tax.

although Lt. Gov. Wayne Mixson has said Graham would be willing to repeal the tax if it proved harmful to business. Mixson doubles as commerce secretary with the primary job of attracting new and expanding business to Florida.

The protest campaign is the repeal of the unitary tax. Graham said Tuesday, "Florida has one of the most moderate taxes on individual Floridians and on business of any state in the country. Our corporate income tax is one of the lowest in the country. We're lower than most of our southeastern neighboring states, we're substantially lower than other, more industrialized, states in the Northeast and Midwest."

Graham said businesses are more concerned with the quality of Florida's education system than the effect of the tax and are willing to pay higher taxes to improve schools.

The new school law changes the way corporate income taxes are computed in Florida by considering profits worldwide, rather than just nationwide. The new tax also applies to the earnings of some affiliated corporations in computing a Florida firm's corporate tax. Furthermore, profits on exports, which were once deductible, now will be counted as part of a corporation's Florida earnings.

Shebel acknowledged that most Florida corporations would rather have the unitary tax on the books than an increase in the corporate income tax because they do not have international sales and, therefore, will not be affected.

Mixson supports repeal of corporate unitary tax

Tampa Tribune 10/7/83

The tax as part of an education funding bill has sent a shock wave through the Florida business community.

• Citicorp plans to move headquarters to Tampa — JA

By HARRY COSTELLO
Tribune Business Editor

LI. Gov. Wayne Mixson "heard the call of Florida's business community" and dropped forward Thursday in support of the repeal of Florida's controversial unitary tax on corporations' worldwide income.

"It's quite evident that the tax is counterproductive and needs to be replaced," said Mixson. "From my perception, we have to find a better

solution." Tampa Tribune 10/7/83

Mixson, who whirled around the state to attend plant openings and other business affairs, wears the dual hat of Secretary of Commerce. In his travels during the past few months, he has felt the brunt of criticism from the state's business leaders who are bitterly opposed to the new tax.

It's become quite evident that the tax just helps price us to pay for sacrificing the strength of a growing economy," he added.

He unveiled his plan to push for the repeal of the tax during a speech to the Florida Industrial Development Council in Destin. He then carried his pitch to Tampa, where he attended ceremonies Thursday evening marking the startup of construction on a new Citicorp Service Inc. headquarters.

Citicorp chairman John Turt-

See TAX, Page 6A

Tax

• From Page 1A

been passed that if the unitary tax had been placed prior to the completion of the bill, the decision would have been postponed and another city outside Florida would have been considered.

Tertburn told The Tribune that further expansion efforts for the Citicorp operations here are on hold pending the proposed repeal of the tax.

Shortly after Mixson made his announcement, Citicorp spokesman James Shabli expressed support for the repeal, but also urged caution among Florida's business community to begin making recommendations for new taxes to replace the revenue source.

"Those who suggest replacing the unitary tax with an increase in the corporate profit tax could be working to defeat the overall effort," Shabli added.

The spokesman for the state's largest employer, the state's business lobby said that while only 5 percent of the state's businesses will see their taxes increase from the unitary tax, most of the state's corporate community would feel the effect of an increase in the state's corporate profit tax.

Mixson said he has made no specific recommendations as to what the tax should be replaced with. Any suggestions would be studied by his cabinet over the next year and dealt with properly during the 1984 legislative session," he added.

As the state's chief business recruiter, Mixson said he supports the needs for an expanded and improved education system.

"Business is asking us to provide it and they must expect to help finance it," he said.

Shabli said he believes there are sufficient voices in the legislature to support the repeal of the tax, if an

acceptable alternative can be found.

Since the tax was passed as part of an education funding bill in June, the state's business leaders have been screaming for its repeal. Pressure has been mounting on Gov. Bob Graham to call a special legislative session to have the tax repealed and replaced with a more acceptable taxing system.

But Graham and legislative leaders have been reluctant to do so.

The governor is traveling in the Far East and was informed of Mixson's proposal in a telegram from the lieutenant governor late Wednesday. Graham was scheduled to hold a press conference in Hong Kong today, where he was expected to react to Mixson's announcement.

Mixson said he was disappointed that Graham refused to his departure for the Far East and told him of the "cold reception" the Department of Commerce was receiving in trying to entice companies to move into Florida or expand their existing operations here.

Mixson said Graham's only response was that he still needed to be convinced of the effort, while needing another funding source to replace it.

The tax on foreign sales was expected to generate \$5 million, or almost half of the \$23 million needed to finance the expanded education program.

Mixson said the legislature should dump the new tax if it expects the state to retain its probusiness image.

Asked whether the flip-flop action on the tax would further reduce the state's credibility in building a business-friendly environment, Mixson said the repeal of the tax "will prove to the world's business community that we are serious in our intent to maintain a positive business environment."

Florida was the first state to adopt a foreign-source tax after California's worldwide tax was upheld by the U.S. Supreme Court in late June.

Business tax repeal advocates growing

By Stephen d'Oliveira

Staff Writer

FORT LAUDERDALE — State Sen. Patrick Neal, D-Bradenton, joined the growing list of Florida officials and businessmen calling for the repeal of the state's new tax on multinational corporations.

Neal, chairman of an appropriations subcommittee, was a proponent of the tax, aimed at raising money to benefit state education, when the measure was passed on July 12.

The so-called unitary tax and foreign-source tax provisions of the state's corporate tax law are expected to cost Florida companies with foreign and out-of-state earnings \$95 million.

The unitary tax portion will raise \$32 million.

"The question is whether we did the right thing on the unitary tax," Neal said Thursday night. "There's a growing feeling with the legislature we did not do the right thing."

Neal, given the highest rating in the Senate by the Associated Industries of Florida in 1979 for his pro-business stance, called for the unitary tax's repeal before the annual fall meeting of the South Florida Manufacturers Association.

The meeting was held at the Pier 65 Hotel.

"Business and industry need to unify behind another selective tax source to replace the \$32 million revenue effect of the unitary tax so

that the unitary tax can be repealed in the 1984 legislative system," said Neal.

Neal proposed several tax revenue alternatives, including raising the state's \$10 corporate filing fee to \$300. He said it could possibly raise an additional \$60 million.

The state senator said the passage of the unitary tax has severely hurt Florida's image as one of the best states in the country for businesses to relocate and expand their present operations.

As an example, Neal pointed to the Sony Corporation. The giant Japanese electronics firm said Thursday it no longer considers Florida a good place to invest in light of the state's unitary tax.

Other Florida businesses also have threatened to curtail their operations here if the tax is not repealed.

The Japanese firm invested in MCI, a Fort Lauderdale firm which manufactures mixing equipment for recording studios. Sony now questions whether it should keep the operation in Broward, the Associated Press reported.

"I don't think there was any recognition of what the economic development impact would be," said Neal. "The perception is so severe we're about to undue Florida's reputation as the No. 1 business state."

Gov. Bob Graham opposes repealing the unitary tax unless an acceptable alternative revenue is found. "We're not going to retreat from our



Sen. Patrick Neal

commitment to education," Graham said Tuesday.

Lt. Gov. Wayne Mixson, who also serves as Florida's secretary of commerce, already called for the controversial tax to be repealed last week. Secretary of State George Firestone also wants the tax repealed.

L. Scott Martens, president of the South Florida Manufacturers Association, said Thursday he can't understand why the state would jeopardize "\$1 billion worth of new business for a million dollars worth of taxes."

Martens, senior vice president of Arvida Realty Sales' commercial industrial division, said the business community believes in education, but said the unitary tax will discourage future business investment in Florida.

The new \$95 million corporate tax was part of a \$200 million tax package to improve public schools in Florida. The state is ranked 46 among the 50 states in terms of state aid to education, Neal said.

The state

Paring down individual exemptions may ease state's fiscal hunger pangs

By Mark Prendergast
Capital News Service Staff

TALLAHASSEE — Floridians pay sales tax on over-the-counter magazines but not on newspapers, on gasoline but not on home heating oil, on fast-food but not on groceries.

In all, Florida law exempts 104 types of sales from the state's 5 percent sales tax, according to records of the House Finance and Taxation Committee.

That leaves buyers of goods and services in Florida more than \$2 billion a year. It also means the state loses that same \$2 billion in uncollected tax dollars and raises fundamental questions of the equity in taxing some purchasers and not others.

Now, thanks to Secretary of State George Firestone and a powerful business lobby, Floridians once more are hearing about removing some of those exemptions. The reason: Big business' opposition to a new corporate tax enacted during a special July legislative session.

To have even a chance of repealing the new tax, estimated to cost businesses \$95 million its first year, opponents must have something to put in its place.

That is because state officials from Gov. Bob Graham on down are adamant that a \$200 million educational-improvement program — funded in part by the \$95 million corporate tax increase — remain intact.

"We are not going to retreat from our commitment to education," Graham declared last week in voicing his opposition to repeal of the so-called unitary tax.

Firestone, however, believes Florida can have the best of both worlds: a well-financed public education system and a happy business community.

His solution: Hold yet another special legislative session to repeal the unitary tax and, to make up the \$95 million difference, remove various unspecified sales tax exemptions. If that doesn't raise enough money, Firestone says, legislators might consider increasing various fees for such things as drivers licenses, death certificates, occupational licenses and corporate charters.

Alternatives that I have proposed are viable and spread the cost of educational improvements across the broadest segment of those citizens



"I strongly feel that the alternatives that I have proposed are viable and spread the cost of educational improvements across the broadest segment of those citizens who will benefit from them."

— George Firestone

who will benefit from them," Firestone said.

Firestone, considered a likely candidate for the 1986 governor's race, will make his recommendation formally to Graham and fellow Cabinet members on Tuesday.

Although all six Cabinet members are individually elected officeholders and therefore owe Graham no allegiance, Firestone's motion is not expected to pass. (Even if it did, it would carry no legal weight. It merely would be an expression of Cabinet sentiment.)

However, the publicity generated by Firestone's proposal supplies additional political ammunition to the pro-business camp and its drive for a special tax session, which legislative leaders oppose.

The question of sales tax exemptions long has been a glowing political coal that the Legislature traditionally has been reluctant to douse. Largely, that is because many — if not most — exemptions have a special interest group behind them.

For example, sales tax is not paid on medical or legal services. Doctors and lawyers, arguing that personal services should not be taxed, are responsible for that. Nor is sales tax paid on funeral, accounting, engineering, architectural, surveying, dental, data processing or dry-cleaning services. Nor do Floridians pay sales tax on haircuts, beauty treatments or Super Bowl tickets.

The special interest behind each of these exemptions should be self-evident. If it's not, it takes only a

suggestion of removing an exemption to bring out the appropriate pressure group. Last session, for instance, even the Boy Scouts got into the act after learning they might lose their sales tax exemption as a non-profit service organization.

Special-interest pressure also is why those who would lop a particular exemption off the list shrink from identifying it early on. To do so only gives an exemption's supporters that much more time to marshal their political forces. Thus, Firestone's non-specific proposal.

The motivation behind many of Florida's 104 sales tax exemptions may stray far afield from altruism, but the justification for others does not.

For example, groceries and medicines are exempt from the sales tax. Like water and household utilities, they are considered necessities and therefore should not be subject to a sales tax.

The desire of a charitable or service organization to hold on to its sales tax exemption is understandable. But one may wonder why certain industries care. After all, one might argue, don't sellers just pass along the cost of a tax to the buyer?

While the answer usually is yes, it also means the price of that particular good or service must go up accordingly, thus risking a decline in demand. And for those businesses, such as law firms, that collect no sales tax, it means a new accounting chore must be added.

The fact that businesses generally pass their costs down the economic

ladder calls into play another argument for exemptions. Namely, that a sales tax is supposed to be a retail tax, paid by the final consumer of a particular product or service.

Therefore, levying a sales tax at each transactional level in the manufacture or delivery of goods and services amounts to double taxation — a tax on a tax — because the final price of the merchandise would be based partly on the cost of sales taxes at the wholesale level.

The Europeans call this a value-added tax. Florida calls it a no-no. Except when it's not called a sales tax.

Part of the pump price for gasoline — a price which is used to compute the additional 5 percent sales tax — is based on other taxes. Likewise for tires. Thus, when Floridians fill up the family wagon or change tires, they are paying a tax on a tax.

The subject of exemptions can be quite confusing to consumers. For example, repairs that involve no materials — just pure labor — are exempt from sales tax. These are strictly personal services. However, repairs that require parts to be replaced are not exempt.

Thus, a labor charge of \$100 for repair of, say, a television set would cost just that. But if it required installation of even a penny's worth of wire, the 5 percent sales tax would be added and the bill would be \$105.01.

Although sales tax exemptions are a legislative sacred cow, lawmakers this year finally realized it was time to take a headcount of the herd.

During the next five years, every one of the 25,000 exemption certificates issued to individuals, businesses and organizations since Florida's sales tax law was first enacted in 1949 will be reviewed. This never has been done before.

Those that are no longer viable or legally defensible will be voided. Those that are, will be renewed. Thereafter, each certificate will have a specific review date.

It is unlikely this paring down of individual exemptions will generate enough new sales tax revenue to offset any repeal of the \$95 million unitary corporate tax. But for a Legislature ravenous for more dollars without having to pay the political price of a tax increase, it may help in some small way ease the state's fiscal hunger pangs.

Multinationals unite to fight unitary tax

By George Oves
Business Writer

More than two dozen multinational companies with operations in Florida have banded together to fight for the repeal of the state's unitary tax law.

Among them are Englehard, a Miami attorney representing the 36 multinational high technology, oil, chemical, and retail companies, said the companies all have "a significant presence in Florida" and believe "the Legislature never got a chance to understand what it all takes in practice."

Englehard said the companies would have an adverse effect on Florida's ability to attract new companies and on the expansion plans of existing businesses if not repealed.

He said the tax would also affect Florida's ability to keep businesses from relocating to other states.

"Our task is to clarify what is happening and

what will happen," Englehard said. "I really believe that once they [legislators] are told what the effects are and how significant and how serious the concern is, they will not vote to hold the unitary tax."

The unitary tax was enacted in 1971 to help raise \$60 million for education programs in the state. It extends the state's five percent corporate tax to foreign subsidiaries and to profits made in foreign countries by companies doing business in Florida.

Each company doing business in Florida would pay its share of the tax based on its total worldwide income and sales that are in Florida.

Englehard said the law will have a "damning effect" on purchasers, suppliers and other support businesses. "The effects are massive," he said. "It is not just the tax itself, but the uncertainty of it."

He said that he has seen "a tremendous amount of growth" in Florida's economy since the unitary tax was enacted.

unitary tax law.

For example, he said Citicorp's plans to locate its investment center operations in Jacksonville would be held because of the company's concern with the tax.

Englehard said the group's "common objective is to talk and work together with the Legislature and the governor" to repeal the law but that at this time it would not be presenting alternatives to the law.

He said, however, that the companies are concerned about the state's educational programs.

"They all have said we need good education. But this is not the way to do it, to discourage business. These companies know they have to pay taxes," Englehard said.

The creation of the lobby is the latest in a series of efforts to repeal the unitary tax. A string of events aimed at the repeal of the unitary tax law

These actions include the filing of a bill by Rep. John Cogrove, D-Coral Gables, to repeal the law.

In addition, Lt. Gov. Wayne Mixson, who also serves as secretary of commerce, has urged repeal of the tax law.

And Secretary of State George Furestone has called for repeal of the law on grounds that it hampers the state's economic development.

The multinational group includes: Alcoa, Alcan Cynamid, Bristol Myers Co., Castle & Cooke Inc., The Coca-Cola Co., Colgate Palmolive Co., W.R. Grace & Co., Gulf Oil Corp., Hoechst Inc., International Paper Co., Johnson & Johnson, Marathon Petroleum Corp., Procter & Gamble Co., Sears, Roebuck and Co., Shell Oil Co., Sun Co., St. Joe Paper Co., Trazaco Inc., TRW, Westinghouse Inc., and Xerox Corp.

State kills unitary-tax repeal plan

By Larry Lipman

STAFF WRITER, TALLAHASSEE NEWS-JOURNAL



Graham

Firestone

TALLAHASSEE — A resolution urging the Legislature to repeal a new corporate income tax formula opposed by many business interests was rejected 5 to 1 Tuesday by Gov. Bob Graham and the Cabinet.

The resolution proposed by Secretary of State George Firestone called for a special legislative session to repeal the so-called unitary tax passed by legislators in July as part of a \$233 million education package. The proposal urged the adoption of alternative revenue sources to replace the \$95 million the unitary tax is ex-

pected to raise this year. Under the unitary tax concept, a company's worldwide income is included in the corporate income tax. The new formula exempts taxes on income earned by subsidiaries in some corporations, particularly multinationals, will pay higher taxes to the state but many others will pay less.

Business leaders, economic development agents and foreign government representatives warned the Cabinet that the unitary tax was giving Florida a

black eye in the international business community. Robert Hendry, representing the World Trade Center in Orlando, said the tax caused two major international businesses to cancel plans to move to the Orlando area.

He said a Scandinavian airline that he would not identify dropped plans to relocate its United States headquarters to Orlando after the tax was passed. A British technology company was considering Orlando as its international headquarters until passage of the unitary tax, Hendry said.

Sadami "Chiku" Wada, vice president and assistant to the chairman of Japan's Sony Corp., said the unitary tax was counter to Florida's attempt to promote foreign investment.

"Florida (is) inviting us by right hand and slapping by left hand," Wada said. "If future is high technology, Florida is turning away future because high technology hates worldwide unitary tax."

Wada said Sony may move a Fort Lauderdale plant employing about 600 people to another state because of the tax.

Graham noted that Sony and other Japanese companies have invested heavily in California, which has had a unitary tax for over a decade, and which has a corporate income tax rate nearly double that of Florida.

Wada said California officials were looking for a way to repeal the unitary tax sometime in the future.

"Florida is going to be like California 10 years ago," Wada said. "If California trying to get out of it, why Florida want to get into it? This doesn't make sense."

Graham, who returned Sunday from an economic

The Orlando Sentinel
Wednesday, October 19, 1983

development trip to Japan, said Japanese business men expressed concern about the unitary tax but, "It was not a significant factor in their decision to come to Florida for development, Graham told reporters in a news conference. He said the reason for the decision was "at this time" for Lt. Gov. Wayne Mison to step down from his post as commerce secretary. Mison, who split with Graham two weeks ago by calling for repeal of the unitary tax while the governor was in the Far East, is scheduled to have breakfast with Graham this morning to discuss the future.

"If you are a member of a team you do what the head coach says the team should do," said Graham. Firestone was the only Cabinet member to vote for the resolution. Comptroller Gerald Lewis, attending a National Savings and Loan League convention in Hawaii, did not participate in the meeting. Firestone said he had accomplished his purpose of drawing attention to the need to repeal the unitary tax as quickly as possible.

Jon Shebel, president of Associated Industries of Florida, the state's major business lobbying group, said he hoped the Legislature would convene a special session to repeal the tax when it comes to the capital on Dec. 1 and 2 for regularly scheduled committee meetings.

Graham hinted he would support an alternative to the unitary tax if opponents proposed a specific business-based alternative and could build up the political support necessary to pass it.

However, before he would consider replacing the unitary tax, Graham said it would have to be convinced it was unfair and hindered economic development in states that have a similar tax.

Shebel said business would support alternative business-based taxes such as higher corporate filing fees or the removal of some sales tax exemptions. But he said the business community would oppose replacing the unitary tax with a higher corporate income tax rate.

Capital Report

Battle over unitary tax continues to build, but now is political issue

By Jon Peck

TALLAHASSEE. The battle over Florida's unitary tax continues to simmer like a pressure cooker, ready to explode before long if something doesn't happen to act as a safety valve. The situation has become entangled with the political aspirations of several top officials, and may prove difficult to sort out.

Lt. Gov. Wayne Mixson, who doubles as commerce secretary, acknowledged that

his boss, Gov. Bob Graham, was miffed at Mixson's decision to endorse repeal of the unitary tax. Mixson did not, however, back down from his controversial position, which puts him squarely as an outsider in Graham's usually tight-knit administration.

Secretary of State George Firestone, who earlier expressed reservations about the tax on corporations' international sales, stepped up his efforts by calling for Graham and the Cabinet to call on legislators to hold a special session to replace the unitary tax with increased fees on such things as articles of incorporation and drivers' licenses and with sales taxes on now-exempt things like data processing and legal services and advertising.

However, House leaders flatly rejected abolishing the unitary tax, and

said business leaders would have to come up with a passable alternative before any revisions could be considered. Gov. Graham, in Japan on an economic development mission, indicated he might go along with some modifications of the tax, but would not support repeal. The unitary tax proved a sore spot in Graham's efforts to recruit Japanese businesses to locate in Florida.

Meanwhile, Mixson's future as commerce secretary remained uncertain. Graham planned to discuss the matter at length with his defiant deputy as soon as he returned to the Sunshine State.

The Citizens Council for Budget Research, a business-supported study group, said it has begun surveying Florida companies to assess the impact of the unitary tax on the state's business climate image and Florida's economic development efforts. The group plans to publish the results of its survey when it is finished.



Legislators hear unitary tax system debated

By ANDRES OPPENHEIMER
Herald Business Writer

Florida's recently adopted unitary taxation system could hurt multinational corporations more than similar laws enacted elsewhere in the United States, a top anti-tax advocate said Monday.

Arthur J. England Jr., an attorney who represents 27 multinational corporations that do business in Florida and oppose the new taxation method, told a meeting of Dade County legislators in Miami "nothing has ever been seen like Florida's tax."

But Donald G. Resha, a spokesman for Florida AFL-CIO, told the lawmakers multinational corporations "should pay their fair share of taxes just like everybody else."

Resha said corporations are fighting the unitary taxation system "because they have avoided paying their fair share of state taxes by shifting their profits overseas."

The worldwide unitary tax method, adopted by the Florida legislature earlier this year, is a formula that permits the state to tax a portion of profits

earned elsewhere by corporations that do business in Florida.

The new tax system was backed by Gov. Bob Graham as part of an effort to collect more than \$90 million for Florida's education system.

England, a former chief justice with the Florida Supreme Court, said Florida's new taxing policy is "unparalleled" among the 12 states that have adopted unitary taxation systems.

England said California and other states treat corporations related through common ownership as a unitary busi-

ness group only if the common ownership is "more than 50 per cent."

"Florida, on the other hand, presumes a unitary group if ownership in common is '50 per cent or more,' and then goes further to tolerate a finding of unitary combination even for less-owned entities in certain cases," England said.

"There is a big difference between owning 50 per cent and 51 per cent of a corporation," England said, suggesting that more companies could be subject to Florida's version of the formula.

The state

Unitary tax: why it is so controversial

By Larry Lipson
The Orlando Sentinel

TALLAHASSEE — The worldwide unitary corporate profits tax: It is misunderstood, much maligned and a source of embarrassment to Gov. Bob Graham's administration and state officials trying to sell Florida as a haven for economic development.

Yet most taxpayers don't even know it exists. And even though it is a corporate tax, most businesses in Florida don't even pay it.

So how will the worldwide unitary tax affect Florida firms, and why is the change so controversial?

First, a brief history. Under heavy pressure from Graham and legislative leaders, the worldwide unitary formula was passed during a hectic 15-hour special session on July 13 that brooked no debate on the tax's merits. The haste put to legislators was simple: did they support education and the revenue source they support education and the revenue source they support education and the revenue source they support education?

It was clear at the time that few legisla-

tioners really understood the ramifications of the tax proposal they were supporting. Now, most of them say they favor replacing it with some other tax source.

Until the unitary tax was passed in the whirlwind special legislative session, Florida corporations were taxed using a formula that companies could avoid by operating outside the state. The United States corporations, for example, pay more or less tax in the state, how does this ratio work?

Florida also gave corporations a tax exemption on income produced outside the United States.

The "worldwide" or "foreign source" provision adopted in July removed the exemption on foreign income and expanded the corporation to show Florida's share of a corporation's worldwide operation.

The formula determines what portion of a corporation's business is attributable to Florida by measuring a corporation's sales, payroll and property in Florida compared with its worldwide sales, payroll and prop-

erty. Sales are given a double weight in the formula, a condition that also existed before the method was changed.

The "unitary" provision of the new law says basically that if a corporation is part of a "unitary business group," it must show what portion the Florida corporation earned in comparison to the entire group of subsidiaries and parent companies.

Unitary business groups are interrelated companies that have a "flow of value so that they are doing business like one big business rather than a lot of little businesses," said a legislative tax specialist. To be considered unitary, the businesses must have a unity of ownership, operation and use.

In California, unity of ownership was defined as more than 50 percent. Florida defines it as having a controlling interest. But if that interest is less than 50 percent, the burden of proving unity of ownership is on the state.

Operation means that the companies share the same management or operate in conjunction in areas such as refinement,

purchasing and advertising. Unity of use means that companies are in the same business or are vertically integrated in complementary businesses.

Together, the changes mean that Florida corporations — or foreign-owned corporations operating in Florida — now have to compare their Florida business to their corporate group's entire worldwide business.

What the changes mean, when the arithmetic is done, is that "the pot got bigger but Florida's piece got smaller," said Bill Zeno, research director of the state's Department of Revenue.

Whether an individual corporation's taxes will increase, decrease or remain the same depends on whether the corporation, along with its unitary parent and subsidiaries, is more profitable in the United States or in its foreign operations.

Those that are as profitable overseas as they are in Florida will not be affected by the tax method because the increased profitability will be reflected in the unitary rate. The unitary rate will be offset by a proportionately smaller Florida

share. But companies that are more profitable overseas will pay a larger share of the tax because the total increase in earnings will not be offset completely by the smaller Florida portion. Conversely, companies that are more profitable in Florida than overseas will pay less corporate tax.

One reason the unitary tax method has drawn heavy fire from multinational corporations is that they generally are more profitable overseas.

Another element adopted in July changed the way sales are computed. Before, if a company sold oranges to a distributor in London, there was some question of whether the sale took place in Florida or London. If it took place in Florida, it counted as a Florida sale and increased the firm's taxable portion. If the sale took place in London, it was not counted previously.

Imposition of the so-called "throw back rule" actually means that such sales are considered Florida sales if the other jurisdiction does not count the sale toward its own income tax.

Corporate, state officials square off on unitary tax

By STEPHEN K. DONG

Herold Wire Service

TALLAHASSEE — The controversial unitary income tax in Florida is a fair and equitable way to apportion the tax load among businesses, California's leading tax official told a Florida Senate committee Wednesday.

"The unitary accounting principle is a realistic, sane way to collect taxes," said Ken Cory, chairman of the California Tax Council.

Cory's congressional testimony was part of a series of arguments by supporters of the unitary tax, which would be paid by a few other supporters touched off an explosion of indignation from business executives gathered to protest

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about perception to show up for the beginning of the meeting, but as the afternoon wore on, the unitary tax's attention span was thin. By the end, only four senators remained.

The unitary method, adopted earlier this year in Florida, permits the state to tax a portion of profits earned abroad by corporations that are based in Florida or do business in Florida.

Sen. Gwen Margolis (D., Miami Beach), chairman of the committee, said afterward that the burden still is on business to come up with an alternative to the unitary tax.

"There won't be a special session unless there are revenues to replace [the unitary tax method]," Margolis said. "If they feel better about work, I think they better work rapidly to come up with a consensus."

And there was little sign Wednesday that a consensus is emerging yet from business. Each anti-unitary witness, when asked about his or her choice of alternatives, de-

clined to answer. Meanwhile, representatives from Florida's business community met with the chief executives of IBM, Ford Motor Co. and other multinational corporations Wednesday at a peace-making session at the Treasury Department in Washington.

Both sides made it clear the states' need for money and the corporations' objections to how they get it present near irreconcilable differences. Three months of meetings are planned.

The relatively new system of corporate taxation is applied by 12 states. The system is based on the worldwide income of multinationals corporations with operations

within their borders. In the first session both sides agreed to have two task forces of subcommittees work on some of the rights issues. The task forces will be made up of representatives of the states and the federal government.

But President Reagan asked that a compromise be worked out without generating a Supreme Court test of the federal government's rights to tax the income of corporations.

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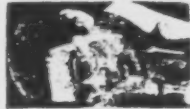
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Region

Gainesville Sun
•• Thursday, November 3, 1983

State news 2C/Obituaries 8C

Business lobby pushing for special session to repeal tax

By LLOYD DUNELBERGER
Sun-Capitol Bureau

TALLAHASSEE — A major business lobby said Wednesday there may be a special session in December to repeal the new corporate income tax. However, Sen. Gwen Margulies, D-North Miami, whose Finance and Tax Committee is holding a lengthy hearing on the tax Wednesday, said she doesn't think there will be a special session to repeal the tax to raise \$25 million. "The legislature is not going to do that," she said. Despite lengthy arguments, few opponents Wednesday offered concrete counterproposals, although many

said they would support "acceptable" alternatives. The a special session from legislators, who were in Tallahassee for this week for committee meetings. And he said his group is pushing for a special session as early as December. But Sen. Don Gandy said a special session unless an alternative tax was proposed and supported by business leaders.

Howard Decker, general manager of IBM's Boca Raton office, said he would support a special session in July, was aimed at providing for improvements in the state's education system. Among its other provisions, the law allows the state to tax multi-national corporations operating in Florida on a portion of their worldwide profit.

See UNITARY on page 3C

See UNITARY on page 3C

2C Gainesville Sun Thursday, November, 1983 ••

Unitary

From page 1C

created a way to \$4.3 million because of the firm's growth.

He also argued that the tax would hurt Florida's ability to attract new business to the state, since they would be in a position to attract new business.

And he argued that firms with foreign operations would be subject to double taxation, since they would be paying taxes to both Florida and the foreign country in which they were operating.

However, in contrast to the Oct. 18 Cabinet meeting where many of the same business representatives argued against the tax, several proposals for tax cuts were offered Wednesday.

Ken Curry, state controller for California, called the method "a realistic, mass way to collect

corporate taxes." Florida based its unitary taxation on the California system, which was upheld by the U.S. Supreme Court before Florida officials decided to adopt it.

In a previous statement, Curry said the unitary method before Florida would become a victim "of a corporate shell game," where firms operating in Florida divert profits out of the state to avoid taxation under the old corporate income tax.

He also said California's tax, which raises some \$500 million a year, has not hurt the state's economic development.

Jere Glover, representing the National Association of Small Businesses, said repealing the tax — and reducing it with a more regressive tax — would hurt small businesses.

"When you say you're going to raise taxes for every small business in the state that bothers me a lot," Glover said.

Graham proposes unitary-tax board

By EMILIA ASKARI
Herald Business Writer

Miami Herald
11-11-83

Florida Gov. Bob Graham confirmed Thursday night that he will appoint a special commission to study Florida's unitary tax and possibly come up with an alternative method of raising money from business to support education.

"My feeling is that there is a need for there to be a forum where the issues can move from emotional to rational consideration," he said. "A lot of the discussion would lead you to believe that we were the Christopher Columbus, that we were the first state to do this. But we're not, we're the fourteenth."

Graham said other states have unitary taxes that are very similar to the one passed by the Florida Legislature this

summer.

Under that law the state may tax a portion of the profits earned abroad by companies based in Florida or doing business in the state.

Graham said he would announce the chairman of the commission tomorrow at a luncheon of the Council of 100. That exclusive group of executives is meeting to discuss world issues at The Breakers hotel in Palm Beach, where Graham is staying this weekend.

The governor made his remarks in response to questions from reporters.

Graham declined to reveal who the chairman will be, except to note that he is not a member of the council.

The governor added that the other 10 to 15 members of the commission will be ap-

pointed in the next few days by himself, the speaker of the house and the president of the senate.

"Probably no current members of the Legislature will be appointed to the commission," Graham said. But former members are possible candidates, he added.

Other members will be drawn from the academic, business and legal communities, Graham said.

The commission will be asked to make its report within 100 days, Graham said.

According to Graham, his recent trip to the Far East triggered his decision to appoint the commission. "I've just come back from spending a week in Japan, where this issue has a great deal of interest," he said.

Business News

Saturday, November 12, 1983

The Miami Herald

4B

UF business dean named to head unitary-tax panel

By PATRICIA BELLEW
Herald Business Writer

Robert F. Lanzillotti, dean of the University of Florida's College of Business Administration, Friday was appointed chairman of a special commission to study the controversial corporate unitary tax.

His appointment was announced at the Breakers Hotel in Palm Beach by Gov. Bob Graham in a speech before the Council of 100, an exclusive group of the state's business leaders.

The commission will assess the impact of the unitary tax on the state's business climate and determine, if any, substitute tax could be levied on business instead of the unpopular unitary tax.

In addition, the commission will evaluate the cost of administering and assessing corporate taxes.

In an interview after his speech, Lanzillotti said that it would be "premature" to discuss substitute taxes until after the commission had met.

Graham, Senate President Curtis Peterson and Speaker of the House Lee Moffitt will be among the other persons as members of the commission, which will report its findings before the start of the 1984 legislative session in April.

The corporate unitary tax, passed by the Florida Legislature in August, has stirred a storm of criticism from the state's business community.

The tax, which could generate \$95

state's educational system, has been declared a "disaster for business growth" by business and pro-development groups.

"I am aware that some business people are unhappy" with the tax, Graham said in his speech to the Council of 100. "I am also aware that for most businesses the tax has no impact."

"I am willing to modify [the tax] according to our special conditions," he continued. But "we are not going to blow a \$95-million hole in our newly found national reputation for educational excellence."

"We are not going to relent, we are not going to repeal" the tax, he said.

Florida's business community "will have to come to the table with a substitute tax" if it wishes the unitary tax lifted, Graham insisted.

Though he said he would allow himself to be "influenced, but not bound" by the commission's findings, Graham stressed that he does not believe the tax will hamper economic growth in Florida.

In states such as California and Massachusetts that also have imposed a unitary tax, "businesses have adjusted and [the tax] hasn't had an adverse effect on development," the governor said. The unitary tax "simply isn't the death knell that everyone tries to portray it to be."

Lanzillotti, 62, recently was one of three final candidates for the presidency of the University of Florida in Gainesville.

Robert F. Lanzillotti

Chairman of unitary-tax commission

Professional

Graduated with a bachelor's and master's degree from American University in 1946-47 received a Ph.D. from University of California (Berkeley) in 1953 served as chairman of the economics department at Michigan State University currently dean of the College of Business Administration at the University of Florida

served as a member of President Nixon's price commission in 1971-72 currently chairman of the Economic Advisory Board to the Governor of Florida is on boards of Jim Walter Corp. and Florida Blue Cross-Blue Shield

Quote

He was selected because he is "intellectually independent and... a very well-respected economist and academician."

Bob Graham



Personal

Born in Washington, D.C. lives in Gainesville

married to Patricia Joy Jackson has one son, Robert J., and one daughter, Donna J.

was recently a candidate for the UF presidency but lost out to Palm Beach lawyer Marshall Crier

strategy for economic development?

Does it have such a negative image that it does damage to Florida's economic climate?

What are the tax's compliance and administrative requirements?

What has been the experience of the dozen other states which have had the tax longer than Florida?

Why would it be the corporate-based replacement for the unitary tax if it were amended or repealed?

This story: Jeon supplemented by

NEWS/SUN SENTINEL, SUNDAY, 1/29/84

Corporate tax hurting state's attractiveness

By Gail DeGeorge
and Elizabeth Roberts
Business Writers

High on the list of issues facing state legislators when they convene in April will be Florida's new and controversial corporate tax.

Passed in the final hours of a special July session, the unitary tax has met strident opposition from business and industry leaders who contend the method of raising revenue for educational improvements will prove costly to the Sunshine State.

Opponents of the tax — which considers a company's total income from world-wide operations and assesses the proportion generated in Florida — say it will discourage large multinational firms from setting up or expanding operations in the state. About a dozen states use a unitary method of corporate taxation, but none of the southeastern states, considered Florida's toughest competition for attracting industry, have such a tax.

Several giant corporations, including Harris, Sony and Motorola, warned legislators that they would consider the tax as a factor in future plans for their Florida facilities.

International Business Machines confirmed earlier this month that it was canceling a proposed expansion, citing the unitary tax as one of the reasons for not increasing its leased office space.

"Taxes are certainly one of the premier things that go into a lottery list of considerations when corporations are looking for a place to invest," explained Dennis Nason, president of Florida International Bankers Association, Inc. in Coral Gables.

"It's not just Florida vs. Georgia, but the U.S. vs. the Grand Caymans or Canada and there is a very negative impression of this tax abroad."

Proponents of the tax — including Gov. Bob Graham — maintain other states will soon adopt the method of taxing companies to offset cuts in federal funding. The expected revenue, they add, is needed in Florida as part of a \$237 million tax package to improve public schools. Better schools are vital to attract coveted high-technology firms, many of which depend on a skilled and educated labor force.

Corporate executives agree that Florida's schools need improvements and more money, but say the unitary tax is a poor way to achieve those goals.

"My clients are disgruntled about this tax, and to varying degrees," said Basil J. Zaloom, tax partner with the Miami office of Coopers & Lybrand, an international accounting firm. "One of the major problems is that it is difficult for them to get a feel for its impact, because they have to take all their domestic and foreign operations and convert accounting procedures to U.S. accounting principles and currency."

"It will cost them more money just to comply with the new rules, and the bottom line is that when they are all done, they will probably pay more tax."

Many of the proposal's original supporters, including state Rep. Peter Deutsch, D-Sunrise, and Lt. Gov. Wayne Mixson, also secretary of commerce, have since agreed that the measure should be substantially modified or repealed.

Graham resisted pressure from political and business leaders who wanted a special session called to repeal the tax. But in response to demands that the issue be examined more fully, the governor appointed a commission of accountants, attorneys and academicians to study the impact of unitary taxes in other states, and assess its potential impact on Florida.

The 19-member panel includes staunch opponents, such as Howard Davidson, general manager of IBM, and a representative of Harris Corp. In charging the group with exploring the impact of the tax, Graham said at its first meeting earlier this month that he will be "influenced" by its findings but not bound by them — especially if the panel urges repeal.

Any proposals to modify the tax must be accompanied by an alternative method of funding public education improvements, he added.

"The whole thrust of the education program says companies will want to move in because education is better, but that is just another factor that is thrown on the table," said Dan Schereer, IBM spokesman, shortly after the tax was passed. "It's clear we're staying in Florida, but it is the only state in the whole Southeast that has a tax like this and it doesn't make Florida all that attractive to other companies."

UNITARY TAX STUDY COMMISSION MEETING

JANUARY 4, 1984

TALLAHASSEE, FLORIDA

COMMISSIONERS IN ATTENDANCE:

Boyd; H. Brown; J.C. Brown; Cejas; Cooney; J. Davidson;
Davis; Drake; Haben; Johnston; Kibler; Lanzillotti; Rist;
and Wright

WITNESSES APPEARING BEFORE THE COMMISSION:

Governor Graham; S.D. Alexander, Department of Revenue; T.H. Swindal, Department of Revenue; S. Jim Barger, Department of Revenue; Bill Zuna, Department of Revenue; Karen Walby, Governor's Office; Larry Levy, Department of Revenue; and Dr. Jim Francis, Staff, House Finance & Tax Committee.

MEETING CONTENT:

The Commission received its charge from Governor Bob Graham. Representatives of the Department of Revenue and the Governor's staff presented information on the content of Senate Bill 3-C and the revenue projections associated with its passage.

No Commission action taken.

UNITARY TAX STUDY COMMISSION MEETING

JANUARY 18, 1984

TALLAHASSEE, FLORIDA

COMMISSIONERS IN ATTENDANCE:

Boyd; Cooney; H. Davidson; J. Davidson; Davis; Drake;
Harris; Hesch; Johnston; Kibler; Lanzillotti; Ravenell;
Rist; and Wright

WITNESSES APPEARING BEFORE THE COMMISSION:

Eugene Corrigan, Executive Director, Multistate Tax
Commission; Arthur England, Jr., Esq., Counsel to the Ad Hoc
Group of Corporate Taxpayers; Dallas Hurston, Assistant
Treasurer, The Coca-Cola Company; John Shebel, President,
Associated Industries of Florida; Richard Hunt, Esq.,
Counsel for Associated Industries of Florida; Carlton
Jackson, Executive Director, Florida Petroleum Council;
Norman Rusch, Shell Oil Co.; J.C. Mallory, Vice President of
Operations & Engineering, Utility Power Corporation; Dennis
H. Nason, Senior Vice President, Credit Suisse, President,
Florida International Bankers Association; Jerry Glover,
National Small Business Association, Washington,

D.C.; George J. Moore, Chairman, Florida Council of International Development; Hon. Kagechika Matano, Consul General of Japan, Atlanta, Georgia; Hon. Makoto Utsumi, Minister for Financial Affairs, Japanese Embassy, Washington, D.C.; Sadami "Chris" Wada, Vice President, Sony Corporation of America; William Shelly, Economic Consultant, Florida Chamber of Commerce; Milton Fisher, Chairman, Florida Tax Coalition; John F. Euart, Executive Vice President, Fairfax Properties, Inc., Atlanta, Georgia; Judy Johnson, League of Women Voters of Florida; Joe Vic, Assistant Plant Manager, Monsanto Company; Mary Lou Lackey, Regional Director State Relations, Motorola, Inc.; and Tom Reilly, Chairman, Committee on State Taxation, and Associate Director State and Local Taxes, The Procter & Gamble Company.

MEETING CONTENT:

The Commission received testimony.

No Commission action taken.

UNITARY TAX STUDY COMMISSION MEETING

FEBRUARY 6, 1984

TAMPA, FLORIDA

COMMISSIONERS IN ATTENDANCE:

Boyd; J.C. Brown; Cejas; Cooney; H. Davidson; J. Davidson;
Davis; Drake; Haben; Harris; Hesch; Johnston; Kibler;
Lanzillotti; Ravenell; Rist; and Wright

WITNESSES APPEARING BEFORE THE COMMISSION:

Ken Cory, Controller, California Franchise Tax Board; Gerald
Goldberg, Executive Director, California Franchise Tax Board;
Dr. Richard Cooper, Economist, Coopers & Lybrand; George M.
Stark, Legislative Chairman, Tampa Bay International Trade
Council; Steve Mayberry, Director of the Division of
Economic Development, Department of Commerce; Dr. James
Zingale, Director of Economic & Demographic Research, Joint
Legislative Management Committee; Dr. Karen Walby, Economist,
Governor's Office; T. H. Swindal, Department of Revenue.

MEETING CONTENT:

The Commission received testimony.

Two subcommittees were appointed:

Report Drafting: Lanzillotti (chairman);
Harris; Hesch; and Kibler.

Revenue Alternatives: Drake (chairman); Cejas; Davis;
Ravenell; and Rist.



GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

UNIVERSITY OF FLORIDA · GAINESVILLE 32611

Robert F. Lanzillotti, Dean · 904-392-2397

February 14, 1984

MEMORANDUM

TO: Members of Unitary Tax Commission

FROM: Robert Lanzillotti, Chairman
Report Drafting Subcommittee

SUBJECT: Results of 2/9/84 Subcommittee Meeting

The Report Drafting Subcommittee, consisting of Marshall Harris, Jerry Hesch, Burke Kibler and I, met on February 9, 1984.

Report Format/Characteristics

We agreed that our Commission's report will probably be widely distributed, both within Florida and in other states considering the subject of unitary taxation. The final document should therefore be a full report, which addresses:

- * The background of SB 3-C
- * The formation of the Commission
- * The Governor's charge to the Commission
- * The evidence presented to the Commission
- * Our findings, conclusions and recommendations

On the other hand, we do not want the report to be so lengthy or technical that it prevents our intended audience (especially legislators) from reading it in full. To as large an extent as possible, technical information will be attached as appendices to the report.

We will also obtain transcripts of the oral testimony and organize the written materials presented to the Commission into a permanent record to be on file and available for public inspection.

Equal Employment Opportunity / Affirmative Action Employer

Page 2
 Members of Unitary Tax Commission
 February 14, 1984

Finally, we agreed that a bill incorporating our recommendations should be drafted for legislative consideration. Commissioner Kibler will assist with this bill-drafting activity.

Report Content: Brief Answers to Questions

1. Is the Unitary Tax Fair and Equitable to Corporate Taxpayers?

The issue of fairness was the most difficult question faced by the Commission. The determination of fairness depends upon perspective, and arguments were presented on both sides. Although the overall determination is not clearcut, some definitive examples of inequity were presented, particularly in terms of double taxation.

At the bottom line, the issue of fairness is overshadowed by the negative impact being generated by the controversy.

2. Is the Unitary Tax Compatible with Florida's Strategy for Economic Development?

No. Testimony from affected companies may be overstated, but testimony from Department of Commerce, Coopers & Lybrand, etc. demonstrate clear incompatibility.

3. Does the Unitary Tax have such a Negative Image that it Does Damage to Florida's Economic Climate?

Yes. Short term impacts are already being seen and long term negative impacts can be expected to be substantial, particularly in light of Department of Commerce testimony.

4. What are the Compliance and Administrative Requirements of the Unitary Tax?

Compliance and administrative problems and costs will be substantial, both for affected companies and for the State. Additionally, uncertainty of revenue flows, particularly in the near term, will cause tax policy administration problems for the State.

5. What has been the Experience of the Dozen other States Which have Lived with this Tax Longer?

Experience of other states is mixed. California has been used as the ideal model, but current activities (proposed bills, Governor's appointment of study commission, etc.) indicate some re-evaluation and recognition of problems, especially from an economic development standpoint.

Page 3
 Members of Unitary Tax Commission
 February 14, 1984

Florida cannot be compared with California, given geographic and economic base advantages which California has.

Regardless of their experiences, Florida cannot follow the model of any other state. Florida must establish and follow its own tax policy.

6. What will be the Corporate-Based Replacement for the Unitary Tax to Replace the Source of Revenue Needed for our Schools?

Alternatives should meet the following criteria:

- a. Broad-based, not affecting only a small percentage of corporate tax payers.
- b. Corporate-based.
- c. Stable over time, with a revenue growth which maintains pace with the overall State budget.
- d. Predictable revenue generator-with a high degree of certainty.
- e. Consistent with current economic development policy (Governor's charge dealt with consistency with existing policy, not whether that policy should be changed).
- f. Consistent with existing tax policy, which has proven to be successful for Florida.
- g. Generate \$95 million in FY 83-84. Even though the actual amount which would be generated by SB 3-C is uncertain--and will probably be less than \$95 million--Commission recommends that the full amount of the original estimate should be replaced.

Report Content: Conclusions/Recommendations:

Our subcommittee unanimously agreed on the following:

1. Although the facts surrounding the impact of SB 3-C are uncertain in some instances, it is undeniably clear that Florida has generated a controversy which is negatively impacting the State's future economic development. The perception of the problem may be overshadowing the problem itself. However, testimony indicates that the issue is already affecting economic decisions, any perception is therefore becoming reality.

Page 4
 Members of Unitary Tax Commission
 February 14, 1984

2. Therefore, the State should immediately move to eliminate the controversy and to send out positive signals regarding its commitment to economic development.

3. We therefore recommend passage of a new bill, with reinstatement of the following sections:

Section I. Repeal SB 3C

Section II. a. Step up the estimated payment schedule from 80% to 90% of the final tax deemed to be due.

b. Increase the underpayment interest amount from 6% to 12%, and increase the underpayment penalty from 10% to 12%.

Section III. Tax foreign source income at a rate not greater than neighboring sunbelt states (except Texas, which has no corporate income tax):

- a. 100% of dividend income to be excluded (to match the exclusions given by Georgia, Kentucky and Mississippi)
- b. Exempt the income generated from export sales of products produced in Florida (as an additional incentive for firms to bring their production facilities to Florida).
- c. International banking income should be taxed at a rate no greater than under current provisions.

4. All provisions relating to worldwide Unitary and throwback should be eliminated.

5. The amount generated by these foreign source income and other reinstatements will be deducted from the \$95 million estimate to determine the amount of the required alternative package.

RFL:rcm

To: Governor's Unitary Tax Study Commission

From: Mildred Ravenell for Subcommittee on Alternative
Revenue Services

Date: February 15, 1984

Subject: Subcommittee Meeting of 2/13/84

On February 13, 1984, the Subcommittee on Alternative Revenue Sources of the Governor's Unitary Tax Study Commission met in Tallahassee, Florida. Subcommittee members present were: Wayne Davis, Fred Drake (Chair), Mildred Ravenell and Carl Reit.

After extensive discussion marked by significant input from and dialogue with members of the audience, the subcommittee concluded that the following package, if enacted, would raise approximately \$98 million in revenue for the state of Florida. To summarize, the package contemplates:

(in millions)

1. Continuing the repeal of the exemption in Chapters 220
for income from export sale business \$20
2. Enactment of a Net Worth Tax comparable to that
presently in existence in Georgia 35
3. Increase of corporate filing fees (annual registration

statement) from the present \$10 to \$50 annually

13

4. Amendment of Chapter 212 (Sales and Use Tax) to repeal the exemption for Sales of Computer Software and Services

30

\$98

A more detailed discussion of each item follows:

A. THE PACKAGE

1. Foreign Source Income Exemption

The foreign source income exemption which was removed by SB3C was discussed. The subcommittee agreed that there should be no attempt to reach foreign source income which was in the form of dividends, interest or royalties. However, there was unanimous agreement that foreign source income resulting from export sales should be included in the taxable base. Florida is the only state in the SUNBELT which presently exempts such income from taxation. Thus, it appears that the state would suffer no competitive disadvantage by taxing such income. The general perception was that the exemption was, when enacted in 1971, an unnecessary concession that has now become economically undesirable.

Note that the subcommittee has not recommended exclusion of income from foreign sales on products manufactured in Florida. We recognize, however that state policy is to

encourage firms to manufacture in Florida. The estimated cost of such an exclusion would be around \$1 million.

2. Net Worth Tax

Enactment of a net worth tax is suggested as an alternative revenue source. This would be a tax based on net worth, including capital stock and paid in and earned surplus of domestic corporations. For foreign corporations, the tax would be levied against the proportion of issued capital stock and surplus employed in the state. Such a tax would neither raise the effective tax rate on a corporation's net income, nor run afoul of the Florida constitution's prohibition against a state ad valorem tax. If the Georgia statute were used as a model, each corporation would pay with rates beginning at \$10 for those corporations with a net worth of \$10,000 or less and ranging up to a \$5,000 tax for corporations having a net worth on \$22,000,000. Georgia realizes approximately \$10 million annually from this tax. The substantially higher estimated figure for this state is based upon the significantly higher number of businesses here.

The subcommittee noted that Florida previously had such a tax. The earlier version was repealed in 1971 when the corporate tax was enacted. Nevertheless, the subcommittee feels the recommendation to be appropriate

at this time because such a tax meets many of the articulated criteria (broadly based, corporate sector, stable, elastic, sound from a policy perspective, constitutionally permissible).

3. Corporate Filing Fees

An increase in the corporate filing fees for the annual registration statement is recommended though not at the level originally suggested. D. W. McKinnon, Director of the Florida Division of Corporations, reported that Florida presently has about 300,000 filings annually. Of these, approximately 260,000 filings are made by "for-profit" entities. Thus, an increase to \$50 applicable only to "for-profit" entities would generate approximately \$13 million. Two additional points are of interest here:

- a. A significant percentage of the 40,000 corporations which would be unaffected by the recommended increase are not tax-exempt for federal income tax purposes (i.e., they are not 501(c)(3) organizations). As such, the commission may wish to recommend that the increase apply to all filers. The number of filers thus far in 1984 exceeds significantly the number to this point last year. Accordingly, increasing volumes may result in a significant addition to the amount estimated.

4. Computer Software and Services

Removal of the exemption presently extended to sales of

computer software under the Sales and Use statute is recommended. Taxing these transactions under Chapter 212 would generate approximately \$30 million annually.

B. OTHER POSSIBILITIES

1. The subcommittee discussed recommending that the present 5% rate applicable to corporate net income be raised to $5\frac{1}{2}\%$ or 6%. The publication Florida Tax Services, 1983-84 at page 3 estimates that a 1% levy on corporate net income has a value of \$81.9 million. Thus, based upon this estimate, an increase of $1\frac{1}{2}\%$ could generate approximately \$40.5 million. Under the Florida Constitution, a rate change must be authorized by a three-fifths (3/5) vote of the membership of each house of the legislature.
2. A possible increase in annual filing fees for professionals (occupational licenses for lawyers, doctors and accountants) was discussed. Such a levy would arguably be a broadly based, corporate sector source. However, a number of difficulties exist with the concept:
 - a. If characterized as a tax, its constitutionality would be called into question, certainly as levied against those professionals doing business as sole

proprietors, or partnerships. The Florida Constitution prohibits a tax upon the income of natural persons. There may also be problems where the levy is against those doing business as professional associations. Such groups are not always treated as corporate entities.

- b. If characterized as a fee, the levy runs into difficulty on another basis. Developing Florida law seem to require a direct correlation between the amount of the levy and the costs of regulation or costs of providing services to those regulated. Any excess over the amounts needed for regulation must be earmarked and used for the benefit of those against whom the levy was made. Even if that excess was, in this case earmarked as has been suggested for graduate and professional education, the benefit seems to remain quite indirect.

For all of these reasons, the subcommittee declined to recommend such an increase as a possible alternative source of revenue. No attempt was made to estimate revenue which might be realized from such an increase.

3. Finally the subcommittee noted that repeal of the Sales and Use Tax for some or all professional

services would generate very significant amounts of revenue. However, it takes no position on recommending such a change at this time.

C. CONCLUSION

The subcommittee is of the opinion that the package meets the articulated criterion. It is:

1. broadly based,
2. levied upon corporate sectors source,
3. a stable package which is revenue elastic,
4. a productive and reliable source of revenue,
5. consistent with Florida's current economic development plans and tax policies,
6. consistent with Florida's tax structure as embodied in Florida's constitution and
7. a package which yields \$95 million plus in revenues for the state.

UNITARY TAX STUDY COMMISSION MEETING

FEBRUARY 17, 1984

MIAMI, FLORIDA

COMMISSIONERS IN ATTENDANCE:

Boyd; J.C. Brown; Cejas; Cooney; H. Davidson; J. Davidson;
Davis; Haben; Harris; Hesch; Johnston; Kibler; Lanzillotti;
Rist; and Wright

WITNESSES APPEARING BEFORE THE COMMISSION:

Representative John Cosgrove; Delray Beach Commissioner
Malcolm Bird; Ken Claussen, Esq., Florida Bar, International
Law Section; Ray Kudisch, Vice-President, Florida
Manufacturers' Association; Robert Paul, Esq., Chairman,
South Florida Initiative, 1983; and Edgar A. Freser,
Department of Revenue.

MEETING CONTENT:

The Commission received testimony.

The Commission voted to proceed with its original schedule,
since the meeting of the Federal Task Force was delayed to late
March.

The Commission discussed the report of the two subcommittees
and voted to accept them with amendments. All votes were
unanimous, except that Commissioner J. Davidson abstained on the
vote relating to the revenue alternatives package.

UNITARY TAX STUDY COMMISSION MEETING

MARCH 2, 1984

TALLAHASSEE, FLORIDA

COMMISSIONERS IN ATTENDANCE:

Birchfield, J.C. Brown; Cooney; H. Davidson; J. Davidson;
Davis; Drake; Johnston; Kibler; Lanzillotti; Ravenell; Rist;
and Wright.

WITNESSES APPEARING BEFORE THE COMMISSION:

None.

MEETING CONTENT:

Chairman Lanzillotti reported on communications from four Commissioners who were unable to attend the meeting. Commissioners Haben and Hesch sent letters, which were read into the record, indicating their support of the Commission's report as drafted. Commissioner Boyd had called the chairman and verbally indicated his support of the report as drafted. Commissioner Hyatt Brown had called the chairman and indicated that he had read the report, but did not express a position.

Commissioner Brown moved that, in deference to a request from the Governor, the Commission defer further activity and adjourn until the results of the Federal Task Force become

available to the Commission. The motion was defeated by a 10-3 vote of the Commission, with Commissioners Brown, Rist and Birchfield voting in favor of the motion.

Commissioner Cooney moved adoption of the report as submitted.

Commissioner Drake offered an amendment clarifying the definition of software transactions on which the sales tax would apply. The sentiment of the Commission was that such sales would be taxable only if they became market transactions, and that the Commission would work with the Department of Revenue to sharpen and refine the Commission's proposed statutory language to reflect the Commission's intent.

Commissioner Kibler offered an amendment to refine the language of the report to rely as much as possible on the use of the term "amend" as opposed to "repeal" in referring to the recommendations of the Commission, to reflect the substance of the Commission's proposals with respect to the State's income tax code.

The motion to adopt the report, as amended, was passed unanimously by those present and voting. Commissioner Rist abstained from voting as she had not received her copy of the report and therefore had not yet had the opportunity to review the contents of the report.

At Commissioner Birchfield's recommendation, the Commission agreed to allow Commissioner Rist and other Commissioners not present to provide to the chairman a written vote on the motion to adopt the report, as amended.

Before adjournment, Commissioners Davis and H. Davidson warmly expressed the Commissioners' appreciation and thanks for the chairman's efforts and leadership.

SUMMARY INDEX OF MATERIALS COMPRISING THE
PUBLIC RECORD OF THE GOVERNOR'S UNITARY TAX
STUDY COMMISSION

1. Background Materials

Prior to the initial Commission meeting, each Commissioner received a package of background materials which included:

1. Department of Revenue - Draft Manual
2. Florida Corporation Income Tax Form (F-1120)
3. Instructions for Filing Under the Unitary Reporting Method (F-1061)
4. Commentary on Senate Bill 3-C by Arthur J. England, Jr. (July, 1983)
5. CCH - State Tax Review, "California's Unitary Method of Apportionment Upheld" (June 30, 1983)
6. Arthur Young: "An Election to Avoid the Florida Unitary and Other Tax Changes Enacted in 1983" (November, 1983)
7. Deloitte, Haskins, Sells Letter to Governor Graham dated November 16, 1983 (reporting on survey regarding impact of new unitary and foreign source income tax law)
8. Florida Corporate Tax Receipts 1971-1983 and projections for 1984-1985 (Florida Department of Revenue)
9. Comparative Southeast States Data (Disposable Income/Retail Sales Per Capita, State & Local Taxes)
10. Statement by H. L. Davidson before the Florida Senate Finance and Taxation Committee (November 2, 1983)
11. "A Simulation of the Worldwide Unitary Apportionment Methods Impact on the Corporate Taxes and After Tax Income of Foreign Owned Florida Corporations: An Example for an Electronic Components Manufacturing Firm" (Dr. Karen Walby & William Pugh, Office of Planning and Budgeting, Executive Office of Governor)
12. "The Unitary Method: Thirteen Questions and Answers" Senator Frank Church and Professor Richard Pomp
13. "Oil Companies' Disappearing Profits: A Case for the Unitary Method" Ken Cory, Tax Notes (May 25, 1981)

14. Overview of Alternative Tax Theories, John Harley, 1980.

2. News Clippings and Journal Articles

During the course of the Commission proceedings, the Commission received copies of news clippings and journal articles from various sources. The news clippings included reports from Florida newspapers regarding the response of the business community and various State, local and foreign government representatives to the new corporate tax provisions. The Commission also received news clippings from national news services regarding the federal study group and the activities of other states relative to unitary tax. Several journal articles were also received by the Commission, discussing and evaluating the unitary tax concept.

3. Resolutions and Position Statements

After the passage of SB 3-C, several cities, counties, local chambers of commerce and economic development groups and councils studied the impact of the new corporate tax provisions and subsequently adopted resolutions or position statements on the issue. The Commission received copies of seventeen resolutions or position papers adopted by such groups from all quadrants of the State, each finding that SB 3-C adversely impacted on the State's economic development and concluding that SB 3-C should be repealed.

4. Correspondence and Telegrams Advocating Repeal of SB 3-C

During the course of the Commission proceedings, the Commission received more than seventy letters and telegrams from members of the business community advocating the repeal of SB 3-C. Many of the affected companies that communicated with the Commission provided information regarding the specific tax liability impact of the new corporate tax provisions on their company and the effect of the enactment of SB 3-C on the company's future operations in Florida.

5. Correspondence from Proponents

The only correspondence received by the Commission from a proponent was a letter from Eugene Corrigan, Executive Director of the Multistate Tax Commission.

6. Correspondence from Foreign Governments and Foreign Councils

The Commission received correspondence from the Consulate General of Japan, the British Consulate General and the Swedish Trade Office. Each of these letters discussed the respective foreign government's opposition to a unitary tax system.

7. Written Testimony From Opponents

The Commission received more than thirty written statements from opponents of SB 3-C, many of whom also presented oral testimony to the Commission. The written testimony came from a broad base of sources, including economical development groups; coalitions; multinational, domestic and Florida corporations; economists; foreign governments; and trade associations. Many of the written statements included attachments of studies, news clippings and other material supporting the position of the opponents. One of the most comprehensive written statements received by the Commission was a Fact Book, presented on behalf of an Ad Hoc Group of corporate taxpayers, containing materials regarding the historical perspective of Florida's prior corporate tax statute, the practical problems associated with Florida's new statute, the experience of other states that have adopted worldwide combined reporting, and the factors that influence corporate location decisions. The Commission also received an extensive document prepared by Secretary of State, George Firestone, entitled "Unitary Tax and Alternatives". This document includes a letter from Secretary of State Firestone relating his opposition to the new tax provisions, a section on alternatives to the unitary tax and copies of numerous letters to the Governor and other State officials expressing the concerns generated by the enactment of SB 3-C.

8. Written Testimony from Proponents

The Commission received written testimony from two proponents of the unitary tax method, Judy Johnson of the League of Women Voters of Florida and Mitchell Horowitz of the American Federation of State, County and Municipal Employees (AFSCME). The AFSCME statement endorses the use of worldwide reporting, expressing the position that the alternative method of separate accounting is burdensome, inconsistent and permits multinational corporations to manipulate their books in order to evade paying taxes. The statement of the League of Women Voters of Florida expressed the position that before the unitary tax is eliminated or abolished in Florida, the new tax provision should be given a chance for implementation.

9. Studies and Reports

The Commission received copies of several studies and reports relating to the issues associated with the corporate tax provisions of SB 3-C. The studies covered such areas as state taxation of multinational corporations, the economic impacts and tax alternatives associated with worldwide combined reporting, the viability of Florida's new corporate income tax provisions, practical problems associated with the unitary tax, analysis of the use of the Multistate Tax Commission as a state auditing tool, and the administration of Section 482 audits by the Internal Revenue Service.

10. General Administrative Correspondence

The general administrative correspondence file of the Commission's records includes letters to the Commission from individuals requesting to testify before the Commission, letters to and from Commission members regarding meetings and other administrative matters, requests to the Commission for information regarding Commission meetings and hearings and correspondence relating to other general administrative matters.

11. Other Correspondence

The Commission received letters in response to inquiries made by the Commission from the Department of Commerce, Division of Economic Development, relating to new projects handled by the Department of Commerce from 1982 to January 1984 and a study conducted by the Department of Commerce regarding the difference in corporate taxation between the State of California and the State of Florida. The Commission also received a copy of a report from Gerald Lewis, Comptroller of Florida, regarding the unitary tax and its impact on the international banking industry.

The Commission received a copy of a letter from Florida House Minority Leader, Ronald Richmond, stating that the unitary tax inhibits growth and is not in the best interest of the State and concluding that the repeal of the unitary tax would not require an alternative tax source, since the revenue projections for the current fiscal year are sufficient to cover the budgetary needs of the State. The Commission also received a copy of a letter from United States Senator Paula Hawkins discussing the action relating to unitary tax at the federal level and suggesting that prompt action is necessary to resolve the controversies associated with the unitary tax system.

12. Copies of Letters to Governor Graham

In addition to the copies of letters to the Governor enclosed in Secretary of State George Firestone's report on unitary tax and alternatives, Associated Industries of Florida, Inc. furnished the Commission with the notebook containing copies of several hundred letters and telegrams to Governor Graham from around of world urging the repeal of the corporate tax provisions of SB 3-C.

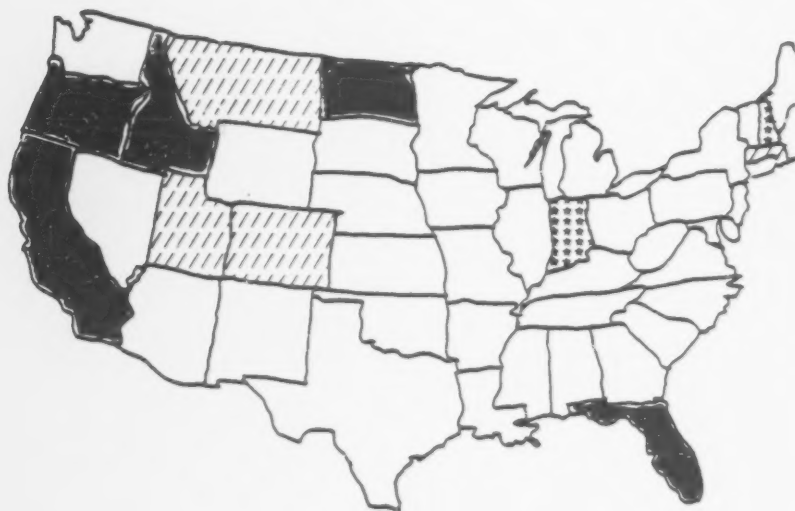
13. Proposed Legislation

The Commission received copies of several bills that were recently introduced in California regarding the modification or elimination of the unitary tax provisions in California. The Commission also received copies of pre-filed 1984 Florida Legislature bills providing for the modification or repeal of SB 3-C.

14. Audiotapes

Cassette audiotapes of each Commission meeting have been placed in the public record. The Commission also received, and placed in the record, a transcript of the January 17, 1984 Commission meeting.

STATES WHICH HAVE ADOPTED A WORLDWIDE COMBINED REPORTING SYSTEM*



-worldwide unitary

California
Oregon
Idaho
North Dakota
Florida

-worldwide unitary, except
with respect to foreign
parent groups

Montana
Utah
Colorado
Massachusetts

-worldwide unitary, except
for oil companies

Alaska

-not actively applying
worldwide unitary

Indiana
New Hampshire

*Extracted from the Fact Book,
presented on behalf of an Ad Hoc
Group of corporate taxpayers,
November 2, 1983.

Example 1
Comparing 1971 Florida Income Tax Code
with Commission's Recommendation

Sales	\$10,000,000
CGS	(5,000,000)
Operating Costs	(3,000,000)
Profit before Taxes	<u>\$ 2,000,000</u>

Assumptions:

1. Sales and profits are allocated, respectively:

Florida	\$6,000,000	and	\$1,200,000
49 states	2,000,000		400,000
Europe	2,000,000		400,000

2. One-half labor force, plant and equipment is in Florida, and the other half is in 49 other states.

Results:

	<u>1971 law</u>	<u>Commission's recommendation</u>
Federal taxable income	\$2,000,000	\$2,000,000
less foreign source income	(400,000)	(200,000) ¹
apportionable income	<u>\$1,600,000</u>	<u>\$1,800,000</u>

Apportionment formula:

2 x sales	(6÷8) ² 75%	(6÷9) ³ 66.67%
1 x payroll	50%	50 %
1 x property	50%	50 %
sum ÷ 4	<u>62.5%</u>	<u>58.335%</u>

¹Can exclude foreign profits only if attributable to manufacture in Florida. Here only one-half of manufacture is in Florida. Thus, exclude only one-half of foreign profits.

²Since we have excluded all foreign income, cannot use foreign sales in determining what proportion of the corporation's total sales occur in Florida. Therefore:

$$\frac{6,000,000}{8,000,000} = \frac{\text{Florida sales}}{\text{Total sales less foreign sales}}$$

$$\frac{\text{Florida sales}}{\text{Total sales less foreign sales attributable to manufacture in Florida}} = \frac{6,000,000}{9,000,000}$$

Tax Calculation:

	<u>1971 law</u>	<u>Commission's recommendation</u>
income	\$1,600,000	\$1,800,000 ⁴
apportionment	x <u>62.5%</u>	<u>58.335%</u>
	1,000,000	1,050,030
tax rate	x <u>5%</u>	<u>5%</u>
tax due	\$ 50,000	\$ 52,501

Conclusions:

1. Florida collects an extra \$2,501 in corporate income tax. This extra 5% pickup was going to other states which did not exclude any foreign source income.
2. The incentive to locate in Florida still exists!! Florida still has the advantage as the double weighting of the sales portion favors manufacture in Florida for sales in other states and countries. Therefore, corporations will locate manufacture in Florida.

⁴Net income after exclusion of foreign source income attributable to Florida manufacture.

Example 2
Comparing 1971 Florida Income Tax Code
with Commission's Recommendation

Sales	\$100,000,000
CGS	(50,000,000)
Operating Costs	(30,000,000)
Profit before Taxes	<u>\$ 20,000,000</u>

Assumptions:

1. Sales and profits are allocated, respectively:

Florida	\$20,000,000	
49 states	60,000,000	
Europe	20,000,000	4,000,000

2. One-half labor force plant and equipment is in Florida, and the other one-half is in 49 other states.

Results:

	<u>1971 law</u>	<u>Commission's recommendation</u>
Federal taxable income	\$20,000,000	\$20,000,000
less foreign source income	(4,000,000)	(2,000,000)
apportionable income	<u>16,000,000</u>	<u>18,000,000</u>

Apportionment formula:

2 x sales	(20:80) 25%	(20:90) 22.2%
1 x payroll	50%	50 %
1 x property	50%	50 %
sum ÷ 4	<u>37.5%</u>	<u>36.1 %</u>

Tax Calculation:

income	\$16,000,000	\$18,000,000
apportionment factor	x 37.5%	36.1%
	<u>6,000,000</u>	<u>6,498,000</u>
tax rate	5%	5%
tax due	<u>\$ 300,000</u>	<u>\$ 324,900</u>

Conclusions:

1. Florida collects an extra \$24,900.
2. Increased taxes for corporation are 8.3%.

Example 3
Setting Example 2 in a state with
no exclusion for foreign source income,
all other factors being equal

Sales	\$100,000,000
CGS	(50,000,000)
Operating Costs	(30,000,000)
Profit before Taxes	<u>\$ 20,000,000</u>

Assumption:

That sales are allocated:

Georgia	\$20,000,000
49 states	60,000,000
Europe	20,000,000

Apportionment formula:

2 x sales	(20÷100)	20%
1 x payroll		50%
1 x property		50%
sum ÷ 4		<u>35%</u>

Tax Calculation:

income	\$20,000,000
apportionment factor	x <u>35%</u>
	7,000,000
tax rate	x <u>5%</u>
tax due	\$ 350,000

Conclusions:

1. Compared to Florida: 1971 Florida corporate tax - \$300,000
Commission's recommendation - \$324,900
2. Even if Florida reduces the foreign source income exclusion, this corporation will still pay less taxes than in Georgia because Florida excludes some of the foreign source income.
3. Note the factors favoring Florida:
 - (1) Florida corporate rate is 5%; lower than 6% in Georgia.
 - (2) Florida's 2x weight to sales in its apportionment formula is more favorable than other states.
 - (3) Foreign source income exclusion under Commission's proposal, although not as broad as under 1971 corporate tax, is still more favorable than other sunbelt states.

Example 4
Setting Example 2 in a state with
an apportionment formula giving less weight to sales,
all other factors being equal

Sales	\$100,000,000
CGS	(50,000,000)
Operating Costs	(30,000,000)
Profit before Taxes	<u>\$ 20,000,000</u>

Assumption:

That sales are allocated:

Alabama	\$20,000,000
49 states	60,000,000
Europe	20,000,000

Results:

Federal taxable income	\$20,000,000
less foreign source income	(4,000,000)
apportionable income	<u>16,000,000</u>

Apportionment formula:

1 x sales	(20 ÷ 80)	25%
1 x payroll		50%
1 x property		50%
sum ÷ 3		<u>41.67%</u>

Tax Calculation:

income	\$16,000,000
apportionment factor	x 41.67%
	<u>6,666,720</u>
tax rate	x 5%
tax due	<u>\$ 333,336</u>

Conclusions:

1. 1971 corporate tax in Florida - \$300,000
2. Commission's recommended Florida tax - \$324,900

Example 5

Same as Example 4 except state has no
foreign income exclusion and does not
give sales as much weight as Florida

Apportionment formula:

1 x sales	(20 ÷ 100)	20%
1 x property		50%
1 x payroll		50%
sum ÷ 3		<u>40%</u>

Tax Calculation:

income		\$20,000,000
apportionment	x	<u>40%</u>
		8,000,000
tax rate	x	<u>5%</u>
tax due		\$ 400,000

ZZZ00000

WHL:pam

Legislative Bill

Draft Date: 02/28/84

GOVERNOR'S UNITARY TAX COMMISSION
(DRAFTING COMMITTEE)

A bill to be entitled

An act relating to corporate income taxation;
amending etc., etc. (title page not completed).

Be It Enacted by the Legislature of the State of Florida:

Section 1. Section 214.71, Florida Statutes, is amended to read:

"Sec. 214.71. Apportionment; general method. -- Except as otherwise provided in ss. 214.72 and 214.73, the base upon which any tax made applicable to this chapter shall be apportioned shall be determined by multiplying same by a fraction the numerator of which is the sum of the property factor, the payroll factor, and the sales factor and the denominator of which is three (3). In the event any of the factors described in subsections (1), (2) or (3) has a denominator which is zero or is determined by the department to be insignificant, the denominator of the apportionment fraction shall be reduced by the number of such factors.

(1) The property factor is a fraction the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year or period and the denominator of which is the average value of such property owned or rented and used everywhere. Both the numerator and the denominator of the property factor shall be adjusted to exclude the value of property attributable to the manufacture of products the sales income from which is subtracted from taxable

income pursuant to Section 220.13(1)(b)(2)(d). In the absence of evidence to the contrary, it shall be presumed that the value of such property is equal to the value of all of taxpayer's real and tangible property owned or rented everywhere multiplied by a fraction, the numerator of which is taxpayer's sales outside of the United States of products manufactured substantially within Florida and the denominator of which is taxpayer's total sales everywhere during the taxable year or period.

(a) Real and tangible personal property owned by the taxpayer shall be valued at original cost. Real and tangible personal property rented by the taxpayer shall be valued at 8 times the net annual rental rate paid by the taxpayer less any annual rental rate received from sub-rentals.

(b) The average value of real and tangible personal property shall be determined by averaging the value at the beginning and the end of the taxable year or period, unless the department determines that an averaging of monthly values during the taxable year or period is reasonably required to reflect properly the average value of the taxpayer's real and tangible personal property.

(2) The payroll factor is a fraction the numerator of which is the total amount paid in this state during the taxable year or period by the taxpayer for compensation and the denominator of which is the total compensation paid everywhere during the taxable year or period. Both the numerator and the denominator of the payroll factor shall be adjusted to exclude amounts paid for compensation attributable to the manufacture of products the sales income from which is subtracted from taxable income pursuant to section 220.13(1)(b)(2)(d). In the absence of evidence to the contrary, it shall be presumed that the amount of such compensation is equal to the amount of total compensation paid everywhere multiplied by a fraction,

the numerator of which is taxpayer's sales outside the United States of products manufactured substantially within Florida and the denominator of which is taxpayer's total sales everywhere during the taxable year or period.

(a) The term "compensation" shall mean wages, salaries, commissions, and any other form of remuneration paid to employees for personal services.

(b) Compensation is paid in this state if:

1. The employee's service is performed entirely within the state;

or

2. The employee's service is performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state; or

3. Some of the employee's service is performed in the state and

a. The base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or

b. The base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed and the employee's residence is in this state.

(3) The sales factor is a fraction the numerator of which is the total sales of the taxpayer in this state during the taxable year or period and the denominator of which is the total sales of the taxpayer everywhere during the taxable year or period. However, the denominator of the sales factor shall not include taxpayer's sales outside the United State of products manufactured substantially within Florida.

(a)1. Sales of tangible personal property are in this state if the property is delivered or shipped to a purchaser within this state, regardless of the f.o.b. point, or other conditions of the sale, or ultimate destination of the property, or if the property is shipped from an office, store,

~~warehouse, factory, or other place of storage in this state; and either the purchaser is the United States Government or the taxpayer is not subject to a tax upon or measured by income in the state to which the sale would be assigned absent this paragraph.~~

2. When citrus fruit is delivered by a cooperative for a grower-member, by a grower-member to a cooperative, or by a grower-participant to a Florida processor, the sales factor for such growers for such citrus fruit delivered to such processor shall be the same as the sales factor for the most recent taxable year of that processor. That sales factor, expressed only as a percentage and not in terms of the dollar volume of sales, so as to protect the confidentiality of the sales of the processor, shall be furnished on the request of such a grower promptly after it has been determined for that taxable year.

3. Reimbursement of expenses under an agency contract between a cooperative, a grower-member of a cooperative, or a grower and a processor will not be deemed a sale within this state.

(b) Sales of a financial organization, including, but not limited to, banking and savings institutions, investment companies, real estate investment trusts, and brokerage companies, shall be in this state if derived from:

1. Fees, commissions, or other compensation for financial services rendered within this state;
2. Gross profits from trading in stocks, bonds, or other securities managed within this state;
3. Interest and dividends received within this state;
4. Interest charged to customers at places of business maintained within this state for carrying debit balances of margin accounts, without deduction of any costs incurred in carrying such accounts; and

5. Any other gross income resulting from the operation as a financial organization within this state.

In computing the amounts referred to in this paragraph, any amount received by a member of an affiliated group (determined under s. 1504(a) of the Internal Revenue Code, but without reference to whether any such corporation is an "includable corporation" under s. 1504(b) of the Internal Revenue Code) from another member of such group shall be included only to the extent such amount exceeds expenses of the recipient directly related thereto.

Section 2. Paragraphs (r) and (bb) of subsection (1) of Section 220.03, Florida Statutes, are repealed.

Section 3. Paragraph (y) of subsection (1), and paragraph (c) of subsection (5) of section 220.03, Florida Statutes, are amended, and paragraphs (cc) and (dd) of subsection (1) of section 220.03, Florida Statutes, are added, to read:

220.03 Definitions.--

(1) SPECIFIC TERMS.--When used in this code, and when not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the following terms shall have the following meanings:

(y) "State", when applied to a jurisdiction other than Florida, means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, ~~and any foreign country~~, or any political subdivision of any of the foregoing.

(cc) "Manufactured" means the process by which material or things are transformed or converted into a different state or form from that in which they originally existed. It does not include mining, processing, agriculture or agricultural processing or any activity which solely enhances the value of material or things without an accompanying change in the state or form of such property.

(dd) "United States" includes all states, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or any political subdivision of any of the foregoing.

(5)

(c) A taxpayer may make an election, in the manner prescribed by the Department, by August 26, 1982, or a taxpayer filing an initial return may make an election upon filing the first return for the tax due under this chapter, whichever is later, to report and pay the tax levied by this chapter, as if the Internal Revenue Code of 1954, as amended and in effect on January 1, 1980, and paragraph (1) of subsection (1), section 220.03, the provisions of chapter 220, Florida Statutes, 1980 Supplement, are in effect indefinitely thereafter.

Section 4. Subsection (1) of section 220.12, Florida Statutes, is amended to read:

220.12 "Net income" defined.--

(1) For purposes of this code, a taxpayer's net income for a taxable year which commences on or after January 1, 1972, shall be that share of its adjusted federal income for such year which is apportioned to this state under s. 220.15 ~~plus nonbusiness income allocated to this state pursuant to s. 220.16~~, less the exemption allowed by s. 220.14.

Section 5. Paragraph (b) of subsection (1) of section 220.13, Florida Statutes, is amended to read:

220.13 "Adjusted federal income" defined.--

(1) The term "adjusted federal income" means an amount equal to the taxpayer's taxable income as defined in subsection (2), or such taxable income of more than one taxpayer as provided in s. 220.131, for the taxable year, adjusted as follows:

(b) Subtractions.--

1. In computing the net operating loss deduction allowable for federal income tax purposes under s. 172 of the Internal Revenue Code for the taxable year, the net capital loss allowable for federal income tax purposes under s. 1212 of the Internal Revenue Code for the taxable year, the excess charitable contribution deduction allowable for federal income tax purposes under s. 170(d)(2) of the Internal Revenue Code for the taxable year, and the excess contributions deductions allowable for federal income tax purposes under s. 404 of the Internal Revenue Code for the taxable year, there shall be subtracted from taxable income, in order to arrive at adjusted federal income, such amounts as reflect the following limitations:

a. No deduction may be allowed for net operating losses, net capital losses, and excess contributions deductions under ss. 170(d)(2) and 404 of the Internal Revenue Code which are carried forward from taxable years ending prior to January 1, 1972;

b. The net operating loss, net capital loss, and excess contributions deductions under ss. 170(d)(2) and 404 of the Internal Revenue Code, respectively, allowable for any taxable year beginning before and ending after January 1, 1972, shall be limited to an amount which bears the same ratio to the taxpayer's net operating loss, net capital loss, and excess contributions deductions under ss. 170(d)(2) and 404 of the Internal Revenue Code, respectively, for the entire taxable year as the number of days in such year, unless the taxpayer elects to account separately for income under s. 220.12(3) of this code, in which case the net operating loss, net capital loss, and excess contributions deductions under ss. 170(d)(2) and 404 of the Internal Revenue Code, respectively, allowable for such year shall be determined on the basis of the items actually earned, received, paid, incurred, or accrued after December 31, 1971;

c. A net operating loss and a capital loss shall never be carried back as a deduction to a prior taxable year, but all deductions attributable to such losses shall be deemed net operating loss carryovers and capital loss carryovers, respectively, and treated in the same manner, to the same extent, and for the same time periods as are prescribed for such carryovers in ss. 172 and 1212, respectively, of the Internal Revenue Code; and.

~~dr No deduction may be allowed for net operating losses, net capital losses, or excess contributions deductions under ss. 170(d)(2), 172, 1212, and 404 of the Internal Revenue Code for non-United States member of a unitary business group.~~

2. There shall be subtracted from such taxable income any amount included therein: by a member of a unitary business group, which amount was received as a dividend paid by another member of the same unitary business group:

- a. Under s. 78 or s. 951 of the Internal Revenue Code;
- b. Which was derived from sources outside the United States as interest, as a royalty, or as compensation for technical or other services;
- c. Which was received as a dividend from a corporation which neither transacts any substantial portion of its business in the United States nor regularly maintains any substantial portion of its assets within the United States;
- d. Derived by a Florida taxpayer from sales outside of the United States of products which, in accordance with rules promulgated by the Department, are manufactured substantially within Florida.

However, as to any amount subtracted under this subparagraph, there shall be added to such taxable income all expenses deducted on the taxpayer's return for the taxable year which are attributable, directly or indirectly, to such subtracted amount.

3. In computing "adjusted federal income" for taxable years beginning after December 31, 1976, there shall be allowed as a deduction the amount of wages and salaries paid or incurred within this state for the taxable year for which no deduction is allowed pursuant to s. 280c of the Internal Revenue Code (relating to credit for employment of certain new employees).

4. ~~There shall be subtracted from such taxable income any amount of nonbusiness income included therein:~~

Section 6. Subsection (1) of section 220.131, Florida Statutes, is amended to read:

220.131 Adjusted federal income; affiliated group.--

(1) Subject to subsection (5), any corporation subject to tax under this Code, ~~except members of a unitary business group,~~ which corporation is the parent company of an affiliated group of corporations may elect, not later than the due date for filing its return for the taxable year, including any extensions thereof, to consolidate its taxable income with that of all other members of the group subject to tax under this code and to return such consolidated taxable income hereunder, in which case all such other members must consent thereto in such manner as the department may by regulation prescribe. Any Florida parent company of an affiliated group of corporations ~~which is not a member of a unitary business group~~ may elect to consolidate its taxable income with all other members of the affiliated group, even though some of its members are not subject to tax under this code, provided:

(a) Each member of the group consents to such filing by specific written authorization at the time the consolidated return is filed;

(b) The affiliated group so filing under this code has filed a consolidated return for federal income tax purposes for the same taxable year; and

(c) The affiliated group so filing under this code is composed of the identical component members as those which have consolidated their taxable incomes in such federal return.

Section 7. Section 220.135, Florida Statutes, is repealed.

Section 8. Subsection (3) of Section 220.14, Florida Statutes, is amended to read:

220.14 Exemption.--

(3) Only one exemption shall be allowed to ~~a unitary business group~~ or to taxpayers filing a consolidated return under this code.

Section 9. Subsection (4) of s. 220.15, Florida Statutes, is amended to read:

220.15 Apportionment of adjusted federal income.--Adjusted federal income as defined in s. 270.13 shall be apportioned to this state in accordance with part iv of chapter 214, and for the purpose of applying said part to this code:

(4) in lieu of the equally weighted three-factor apportionment fraction based on property, payroll, and sales which is described in s. 214.71, there shall be used for purposes of the tax imposed by this code an apportionment fraction composed of a sales factor representing 50 percent of the fraction, a property factor representing 25 percent of the ~~this~~ fraction, and a payroll factor representing 25 percent of the fraction. However, upon application in accordance with paragraph (a), any taxpayer shall be entitled

to a refund of tax, in an amount determined under paragraph (b), if it can establish that the aggregate amount of its net income subject to tax under this code and in all other states for the taxable year exceeds 100 percent of the taxpayer's taxable income, as determined for federal income tax purposes, for the taxable year.

(a) Any taxpayer eligible for a refund under this subsection shall make application therefor in accordance with procedures set forth in part I of chapter 214. All applications for refund under this subsection shall be accompanied by a copy of the taxpayer's federal income tax return for the taxable year, copies of every return filed by the taxpayer in the states in which it has conducted business for the taxable year, and verification in the form of cancelled checks or other receipts of the taxpayer's payments of the amounts shown to be due on the several returns filed with the refund application.

(b) The refund to which any taxpayer shall be entitled under this subsection shall be equal to 5 percent of the lesser of:

1. The excess of the amount subject to tax for the taxable year under this code over the amount which would have been subject to tax if the taxpayer had computed net income for purposes of this code on the basis of the apportionment fraction described in s. 214.71, or

2. The excess of the aggregate amount of net income subject to tax in Florida and in all other states for the taxable year over the amount of federal taxable income for the taxable year.

(c) For purposes of this subsection, the terms "net income subject to tax" and "amount subject to tax" shall mean the amount against which a rate or rates are applied in determining the taxpayer's dollar liability for tax in any jurisdiction.

Section 10. Section 220.16, Florida Statutes, is repealed.

6-89

Section 11. Subsection (5) of section 220.63, Florida Statutes, is amended to read:

220.63 Franchise tax imposed on banks and savings associations.--

(5) There shall be allowed as a deduction from adjusted federal income, to the extent not deductible in determining federal taxable income or subtracted pursuant to s. 220.13(1)(b)(2), the eligible net income of an international banking facility determined as follows:

(a) The "eligible net income of an international banking facility" is the amount remaining after subtracting from the eligible gross income the applicable expenses.

(b) "Eligible gross income" is the gross income derived by an international banking facility from:

1. Making, arranging for, placing, or servicing loans to foreign persons, provided, however, that in the case of a foreign person which is an individual, a foreign branch of a domestic corporation (other than a bank or savings association), or a foreign corporation or a foreign partnership which is 80 percent or more owned or controlled, either directly or indirectly, by one or more domestic corporations (other than banks or savings associations), domestic partnerships, or resident individuals, substantially all the proceeds of the loan are for use outside the United States;

2. Making or placing deposits with foreign persons which are banks or savings associations or foreign branches of banks or savings associations, including foreign subsidiaries of foreign branches of the taxpayer, or with other international banking facilities; or

3. Entering into foreign exchange trading or hedging transactions in connection with the activities described in this paragraph.

However, "eligible gross income" does not include any amount derived by an international banking facility from making, arranging for, placing, or servicing loans or making or placing deposits if the loan or deposit of funds is secured by mortgage, deed of trust, or other lien upon real property located in the state.

(c) "Applicable expenses" are any expenses or other deductions attributable, directly or indirectly, to the eligible gross income described in paragraph (b).

Section 12. Section 220.64, Florida Statutes, is amended to read:

220.64. Adoption of parts III-VI. --To the extent not manifestly incompatible with the provisions of this part, parts ~~I and~~ III, IV, V and VI of this code ~~and ssr-220+12; 220+13; 220+135; and 220+16~~ shall apply to the franchise tax imposed by this part. Under rules prescribed in s. 220.131, a consolidated return may be filed by any affiliated group of corporations composed of one or more banks or savings associations, its or their Florida parent corporation, and any nonbank or nonsavings subsidiaries of said parent.

Section 13. Sections 11 and 24, and subsection (1) of section 26, chapter 83-349, Laws of Florida, are repealed.

Section 14. Subsection (2) of section 607.361, Florida Statutes, is amended to read:

Section 607.361. Fees for filing documents and issuing certificates.

--The Department of State shall charge and collect for:

(2) Filing an annual report, ~~at~~ \$50.

Section 15. Paragraph (h) of subsection (1) of section 212.05, Florida Statutes, is added to read:

212.05 Sales, storage, use tax.--It is hereby declared to be the legislative intent that every person is exercising a taxable privilege who

engages in the business of selling tangible personal property at retail in this state, or who rents or furnishes any of the things or services taxable under this chapter, or who stores for use or consumption in this state any item or article of tangible personal property as defined herein and who leases or rents such property within the state.

(1) For the exercise of such privilege, a tax is levied on each taxable transaction or incident, which tax is due and payable, according to the applicable brackets set forth in s. 212.12, as follows:

(h) At the rate of 5 percent on the sale, rental, use, consumption or storage for use in this state of computer software whether customized or packaged. Computer software is defined to mean information and directions loaded into a computer which dictate different functions to be performed by the computer, whether contained on tapes, discs, cards, or other device or material. The tax shall not apply to computer software produced or fabricated for use by the producer or fabricator or a member of an affiliate group that includes such person. An affiliated group shall consist of a parent company and all subsidiaries of which the parent company owns directly or indirectly 100% of the voting common stock.

Section 16. Severability.

If the provisions of section 220.13(1)(b)2 d, Florida Statutes, as created by Section 5 of this chapter, or the application of such provisions to any circumstance is held invalid for any reason whatsoever, the remainder of the chapter or the application of such provisions to other circumstances shall not be affected thereby.

Section 17. This act shall take effect upon becoming a law, provided that:

(1) The provisions of sections 1 through 13 shall apply retroactively to taxable years beginning on or after September 1, 1982.

(2) Sections 14 and 15 shall take effect _____ 1, 1984.

Senator HAWKINS. Thank you.

It is my understanding that the original justification for the Florida unitary tax was to pay for a new education initiative and stated in the few short hours that transpired during its enactment that it would raise \$95 million for this purpose. But I understand that the State already has moved forward with the new initiative but it has failed to raise the expected revenues to cover the costs through the unitary tax.

Can any of you tell me what the State of Florida is using to finance this new education initiative if it is not the tax revenues from the unitary tax?

Mr. SHEBEL. Senator, there is \$38 million more than anticipated that came in during the fiscal year. The only area of taxation that was down by category was the corporate tax area. They anticipated that unitary would create—and these were the figures of the Governor's staff and the legislative staff—that the unitary method would create a 40-percent growth in corporate tax revenues.

In effect, we had 11-percent growth in corporate tax revenue, or 75-percent less than they anticipated. So, we had less income and corporate tax than was anticipated, but in all other categories, as you know, we live on the sales tax and in all other categories it was up. So, there are those who say that the most recent study and the only study by a private group is the TaxWatch study, and it says in effect that the money is there and the replacement revenue is not needed and points out—and I will quote this—"the actual need for replacement revenue is only a political necessity" and then it goes on.

So that is pretty much where we are.

Mr. LANZILLOTTI. Senator, I might make a comment on that. The commission inquired of the department of revenue about the firmness of estimates of unitary taxation. We in the course of our deliberations were given revision on revision. It is a very uncertain stream of tax revenue.

Originally there was a discussion of \$95 million. Subsequently I heard \$70 million. I do not know what the current estimate is, but I know that the revenue expected from unitary is far short of what was originally anticipated.

My good friend Mr. Cory from the State of California assisted us in this regard by testifying in California that their tax estimates were within a range of plus or minus 40 percent of the number they expected. I think that is a pretty good indication of how uncertain at least we felt and unreliable unitary tax revenue is.

Senator HAWKINS. Dean Lanzillotti, when you look into this issue of unitary tax you keep running right into the issue of business confidence. This kind of talk, however, might seem unimportant to the man on the street or the average person. Why is the issue of business confidence so important to the average guy on the street?

Mr. LANZILLOTTI. I think it is important to the average person on the street in the State of Florida because investment in plant and equipment is important to economic development and is important for job creation. It is important for revenue to the State and if business does not have confidence in the reliability, stability, and consistency of tax policy in the State they will decide to make their investment decisions elsewhere.

So, I think it is vital that a State project a policy on taxes that is foreseeable, fair, understandable, and consistent. I hope as an educator that people understand that unitary taxation clashes very sharply, at least for the State of Florida, with economic development goals. I think it is materially affecting the investment in the State of Florida today, and the long-term outlook is what we should be concerned about, is that unitary taxation worldwide or unitary has a very negative impact on investment decisions both from domestic corporations and foreign corporations in the State of Florida.

Senator HAWKINS. And therefore the parents or the students in your school of business should have some concern about where these young people are going to go to work?

Mr. LANZILLOTTI. I should hope so.

Senator HAWKINS. Mr. Shebel, as you know, Florida had no corporate income tax before 1971, and after 1971 the new corporate income tax gained a fairly favorable rating because it piggybacked on the Federal returns, making it rather easy to use and easy to administer.

What does the Florida unitary tax mean in terms of administrative burden on the State? Would it require an increase in the staff of the State tax bureau, for instance?

Mr. SHEBEL. It would require, Senator, an increase in the staff, and they have already said that. But what it really means is it is virtually almost impossible to administer. As Dean Lanzillotti said and as we pointed out in the report, California evolved into their situation over many years. Ms. Lackey mentioned that there seems to be this inference on unitary that business is hiding something out there.

The way California got into it is that their screen actors felt that there was a shifting of income out. Whether there was or not, I do not know. And so they went out to search for it worldwide. As we have evolved into a—really very quickly in terms of Florida—into an international economy over the past 10 or 15 years, it becomes more and more objectionable, you know, to people.

But as far as how they are going to enforce it, I very candidly do not think they are going to enforce it and I think they are trying to figure out how they can enforce, and they have not figured that out yet.

Senator HAWKINS. Dean Lanzillotti, I would like to ask you a question for the record. I asked it of Mr. Cory, that Sir Roy stated that States should recognize that the U.S. economy is becoming increasingly internationalized since the 1970's.

As an international authority who is well respected throughout the world not only just in Florida, would you say that the U.S. economy has become increasingly internationalized since 1970?

Mr. LANZILLOTTI. I do not think there is any doubt about it. If you would ask economists generally they would reply that the economy has become more open internationally and this has particularly been true for the State of Florida's economy up until the passage of senate bill 3-C.

Senator HAWKINS. Dean Lanzillotti, the effects of the last recession would appear to indicate that Florida is what I call inflation

resistant, not that we do not feel the effects of a national recession but that we do not feel it as strongly as the rest of the country.

Does not the adoption of a unitary tax in Florida link Florida's tax revenues in a detrimental way to the ups and especially the downturns of international recessions?

Mr. LANZILLOTTI. I think that to the extent that any economy is linked more intimately with other economies and the international economy there is likely to be that kind of an impact. Florida did show more resistance to the international recession in 1981 and 1982, and it recovered more quickly and it is a very robust economy today, there is no question about it.

But I think your presumption in your comment is correct.

Mr. SHEBEL. Senator, if I might interject on that, not only on the fluctuations in the international economy but on the fluctuations of the individual corporations, for example, that is little discussed in Florida is that while you may pay more dollars under the unitary approach you may get a refund if you did very poorly overseas, for example.

I am aware of a number of corporations, multinationals, who have told us that they are due a refund. One should get a \$3.2 million refund, and that was never calculated into any of these projections.

Ms. LACKEY. Senator, I would like to address this question, which also ties back to the last question. I think it is important to recognize that there has been an increased internationalism in our economy. For many companies, we are no longer dealing strictly on a domestic basis—not by choice, but out of necessity.

Our products are sold in a highly competitive market and the prices are determined by highly competitive worldwide market forces. It is thus not a matter of having international operations in order to avoid taxation or immunize income from taxation; rather, it is a matter that, where the United States has a very open trade policy, in many instances U.S. companies must have operations in foreign countries in order to gain access to their markets or because it becomes necessary to have operations around the world in order to remain competitive from a cost standpoint.

I think the internationalization of our economy is an extremely important point, and it has made the use of unitary taxation an even more important issue over the last 10 or 15 years than it has been in the past.

Senator HAWKINS. There has been a great deal of talk here in Washington about modifications of the unitary tax to try to soften some of its more controversial issues. Dean Lanzillotti, I understand that your commission looked into some of these. What was the commission's view of some of these modifications, including the often-mentioned water's edge alternative?

Mr. LANZILLOTTI. The commission's position on that was very clearcut. The commission felt that any form of unitary was unwise, whether it was worldwide or water's edge, and the reason being that we felt it put at risk substantial amounts of capital investment by both domestic and foreign corporations in the State of Florida.

So the commission's position was opposition to any form of unitary.

Senator HAWKINS. I have dozens of letters, and I would imagine you have, too, that you received during those hearings you held throughout Florida. All of these Florida businesses express their strong opposition to the unitary tax. I noticed on the makeup of the President's task force or Secretary Regan's task force that those that are for the tax are usually elected officials or tax collectors or in the taxing business, and those that are against it are all businesses.

Why is it important for there to be the perception in the United States that businesses are for paying their fair share but really are not for overpaying?

Mr. LANZILLOTTI. Did you want me to respond?

Senator HAWKINS. Yes.

Mr. LANZILLOTTI. I looked at this. Fortunately, I am an academic.

Senator HAWKINS. That is why I asked you.

Mr. LANZILLOTTI. I can give you my view as an economist. I think that there are difficulties, it seems to me, in treating corporations as though they were a homogeneous type of activity. We heard this morning that BAT is in the business of paper, they have department stores, they have tobacco. I recall that Proctor & Gamble is a very diversified corporation, making coffee, soap, is in the bottling business, and makes pulp—each of these in the United States and abroad.

Each of these lines of businesses has different levels of capital intensity, different degrees of labor intensity, and vastly different rates of return. Unitary taxation with the apportionment of income, it seems to me, acts as though these were uniform, homogeneous types of activities, and I think that it involves an arbitrary shifting of income.

I think it is unwise. I think it is an improper way to tax. I think the separate accounting method is fully capable of handling the tax liabilities assessed by the States. So as an economist I am opposed to this form of taxation, although I had not studied this until I was appointed to this commission.

Senator HAWKINS. If the unitary tax is thought to be such a great idea in bringing all kinds of gold and blessings to States, in your study commission's report you point out that other southeastern States have not followed Florida's lead in adopting unitary tax. In fact, the Governor of Georgia is capitalizing on Florida's new competitive disadvantage by publicly stating that Georgia will not adopt the unitary tax.

There are many other Governors who have taken this same step and made the same statement and mailed letters out to all of these companies that we are so happy to have in Florida and hope that they would expand in Florida.

How unique is Florida?

Mr. LANZILLOTTI. I think you raise a very good point. I certainly respect the right of the State of California, for example, if they feel that unitary is appropriate for them, the State as a matter of policy certainly should be entitled to do that. I think it is erroneous, however, for the State of California or any officials from that State to attempt to generate the impression that economic development in Florida or any other State would not be threatened by worldwide unitary or domestic unitary tax.

The State of California is very unique insofar as its location, the size of the market, the fact that it has a Pacific Ocean on the west, Mexico on the south, and desert on the east. If you wish to do business in the State of California, you probably are going to have to locate in California.

Florida, by contrast, has Alabama, Mississippi, South Carolina, Georgia, North Carolina just north of the State, and corporations have the option of locating and serving Florida and the entire Southeast. So we do not have the unique geographic advantage that the State of California has, and it is clear that some corporations have decided they are going to invest in California, despite the unitary taxation and fight it as a matter of legal action.

I think it would be an unwise strategy for Florida to presume that we have a degree of uniqueness both in size and population and economic markets as California has. We are not that unique. We have competitor States, in effect.

Senator HAWKINS. I understand that because of all of the questions raised and the great resistance to the way Florida enacted the unitary tax that the Governor appointed a blue ribbon commission—at least it is bound in blue, its report.

Mr. LANZILLOTTI. That is Florida blue.

Senator HAWKINS. Yes, for Florida, and appointed a very prestigious group to study this. Now that the report is finished, how did the Governor accept your report?

Mr. LANZILLOTTI. Did you address that to me, Senator?

Senator HAWKINS. Yes.

Mr. LANZILLOTTI. Well, that is a delicate question that you have raised.

Senator HAWKINS. Well, you are an academician.

Mr. LANZILLOTTI. Yes. I am also an educator and I have tried as an educator to persuade the Governor this is a carefully reasoned and analytical approach to the problem, and in every meeting I have had with him I have urged him to read carefully the findings and conclusions and the recommendations. I have not as an educator stopped my educational efforts in this regard.

Senator HAWKINS. With the new TaxWatch reports maybe we can pick up some ideas. How would you assess the likelihood of repeal of the unitary tax in Florida?

Mr. SHEBEL. Senator, the incoming speaker and president, Senator Johnston, and Representative Thompson, have both made it clear that they are not responsible for unitary. It was not their thing. They think it ought to be repealed in December in a special session.

The movement now is to attempt to put together the replacement revenue, even though it is not clear whether there is any replacement needed, and that is the Governor's requirement. So we have come out with a resolution which we have given you a copy of to tax ourselves to do that.

We attempted to run this by the Governor's staff 3 days ago prior to our board meeting after we had cleared the language with the incoming president and the speaker, and they had basically approved it and said that would begin with them. They could go with that.

We could not get an answer from the Governor's office even though the Governor has endorsed everything that is in our resolution and will be in other resolutions that are forthcoming within the next few days. The minority party and the legislature, Representative Pajcic, the minority leader told me yesterday before I came up here that they have been advocating the repeal all along, as you know.

They did not vote for passage as a party of the original bill. But they will vote for repeal as they have every time they have had the opportunity. However, this time they said they will not vote for replacement revenue because they do not think any revenue needs to be replaced. That is a long answer.

The short of it is, I do not know.

Senator HAWKINS. It is a nebulous figure if we cannot get how much they have collected.

Mr. SHEBEL. That is correct.

Senator HAWKINS. But you are telling me that regardless of how much they collected or what they say they have collected you are willing to add that blank check on the businesses in Florida to make up for what might have been lost?

Mr. SHEBEL. Yes, ma'am. We have been told the figure is \$74.6 million that we must replace. Our board of directors has been through this whole thing for 2 years now. You know them very well and how they are. They do not spend money that does not need to be spent. They voted to spend that money to get rid of this form of calculation. So that is where we are.

We are proceeding forward to repeal and replace. Now the legislature has in effect already repealed this bill one time. They repealed it by their vote, and the problem that came up on July 1 was not with regard to repeal. Across the board everybody wanted to repeal it. It was the replacement revenue. Now we are back in that posture. They will vote to repeal again. They know it is not in the best interests of Florida and they want to get rid of it.

The issue is, once again, replacement revenue, and that is up to the Governor.

Senator HAWKINS. I have heard that some firms have refused to pay their unitary taxes, preferring instead to take the State to court over controversial aspects of the tax. Is that accurate, to your knowledge?

Mr. SHEBEL. I am not aware of anybody—when you say refused to pay their taxes, there is a provision in the bill if there is disagreement they can go to a hearing and so forth. That is their process to go through. I am sure as this goes on that there will certainly be some of those, because—particularly the first time you establish your base, so I am sure there will be.

But it is not a refusal in the sense that we are going to ignore you and are not going to pay the tax.

Ms. LACKEY. Senator, if I may answer this, I believe this point addresses the real heart of the unitary matter. The use of unitary is an extremely complex matter—the very determination of what is in a unitary group is difficult to determine and it differs from State to State.

There certainly has been evidence that, in some States which have had unitary taxation for many years, there are firms who

have been paying their taxes into an escrow account for a period of 10 or 20 years because their audits are that far behind. The issues are often that complex.

The definitions and interpretations are also complex, so in many instances—and again I believe this has been the experience of many States who have recently adopted unitary—they have found that revenue collections have been very minimal. In some instances, refunds even exceeded collections in the early years—not because corporations were intending to bypass the tax—but simply because neither the State nor the companies were able to determine immediately what was necessary for compliance with the law.

Senator HAWKINS. Thank you very much for participating in this hearing. Senator Mathias has had an interest in this subject for a long time. My interest was peaked when I saw how rapidly you passed this, in a matter of hours, in the State of Florida, and as a U.S. Senator from that State I feel it has a very detrimental effect.

As a member of the Foreign Relations Committee I can guarantee you that it has a very detrimental effect. We met with many of the foreign leaders and, in fact, the Dutch have made it a nonnegotiable item. You cannot talk to the Dutch about this particular tax, and as we look at these trade deficits and wring our hands about balancing the budget, et cetera, I think Senator Mathias is right in having been concerned these many 20 years that eventually it would catch up with us.

We are building this record in an effort to convince the Congress that we should take action. The Supreme Court said in the absence of the Congress taking action we will take action, and I feel that that is the worst action we take when we elect officials to come up here to legislate to then let the courts decide.

I am always amazed when we ask witnesses what does this mean, yes or no, and they say well, we will let the courts decide. It may be that we could recommend to the voters of America that they could let a lot of us go home and save their money and just go straight to court with those things that the States come up with because there is an absence of gathering of the right documents and the right information here for us sometimes to understand the total complexity of the problem.

I do know that I read on the front page of every paper and every letter that I get now about the trade deficits, which are mounting greatly, and it seems to me very foolish to take a giant step backwards, to close our door to any new jobs, new technology, to any light new industry, which has been the salvation of Florida.

It raised us from a service State, a State that had a lot of wonderful people who carried your bags into the hotels and made your beds and made sure that you got good services during the tourist season, and turned us into a vibrant, attractive productive State with a hospitable climate that is bringing new companies to Florida.

I met with the president of your company, the chairman of the board, in fact, Miss Lackey. He had letters from several Governors in his pocket telling him that if he wanted to expand and relocate to please come to their State. I guarantee you we should never have adopted that onerous unitary tax in Florida because we are looking for more industry, and the unitary tax just scares it away.

That is today's bottom line. Of course, it is the same bottom line on the books of the companies. We are looking for jobs in Florida, for well-educated people to bring a stable economy to our State. I feel that it is the most regressive taxing experience I have ever witnessed and hopefully will be repealed.

But in the interest of those other States that are running into the sea, copying Florida and California and other States because of the Supreme Court's decision, I think they could take a good lesson by looking at this hearing. I guarantee you there is a great deal of interest on this in the Congress.

We appreciate your helping us build this record and I hope that everything will come out all right in Florida. If not, you will see something coming from Congress. Thank you all very much.

[Additional questions and answers follow:]

MR. CORY'S RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED BY SENATOR
MURKOWSKI

Question 1. What steps, if any, have foreign companies taken against your State for imposing the unitary method?

Answer. Foreign business groups and individual foreign companies have threatened not to select California, or other worldwide unitary States, for new plant locations or other investments. It is virtually impossible to isolate the decision-making factors in an investment and to verify whether or not these threats have been carried out.

For example, a September 13, 1984, article in the Wall Street Journal announced a decision by Fujitsu to build two plants in Oregon. The reasons cited for selecting Oregon included "the state's newly favorable tax climate (eliminating unitary), the availability of a highly skilled labor force supported by an excellent educational system, and the pleasant Northwest life style." The tone of the Journal article creates the impression that California lost these plants because of the unitary issue, but there is no supporting statement from the company. All research into reasons for making business locational decisions would suggest that the other three factors cited by Fujitsu, skilled labor, educational system, and life style, are of greater importance in locational decisions than an area's tax climate.

Empirical evidence suggests California has suffered no ill effects from using the unitary method. Seven of the 11 largest banks in California are foreign owned, and California is normally the leading State in attracting foreign corporate investment. Threats of the foreign companies are inconsistent with California's position as the preeminent State for foreign investment since California has long used the unitary method on a wide basis.

Question 2. In your opinion, if the unitary method is limited, will your State face decline in state tax receipts?

Answer. There is no question that there would be a significant decline in California's bank and corporation tax receipts.

The proposal for modifying California's application of the unitary method, supported by Governor Deukmejian, which is based upon Option Two of the Worldwide Unitary Taxation Working Group Report, would cost my State \$200 million in 1984 and increasing amounts in subsequent years. More drastic changes in the present system would cost substantially more. The current upper limit on the various proposals limiting California to a water's-edge approach is conservatively estimated at \$560 million for 1984 with growing amounts for subsequent years. There are studies which support significant higher amounts. These estimates are based upon a number of sources, including data compiled by the California Franchise Tax Board, studies by other states, and studies performed by the U.S. Treasury's staff in conjunction with the Task Force and Working Group deliberations.

Critics of these estimates correctly point out that they do not reflect the benefits from increased economic activity which would result in increases in other taxes, such as sales tax, property taxes, and personal income taxes. The critics neglect to note, however, that all of this hoped for new activity also dramatically increases the demand for costly government services.

MR. SHEBEL'S RESPONSE TO AN ADDITIONAL QUESTION SUBMITTED BY SENATOR
MURKOWSKI

Question. As you may be aware, *after* Florida adopted the worldwide method in 1983, the Alexander Grant Company's survey of State business climates rated Florida as having the best business climate in the nation. Interestingly, 2 of the other top 10 States in the survey, North Dakota and Utah, also use the worldwide method. Doesn't that conclusion by independent, objective observers suggest to you that the worldwide method is consistent with a good business climate?

Answer. It is true that after the adoption of the unitary method of calculation by Florida in 1983, the Alexander Grant & Company survey rated our business climate as No. 1 in the nation. However, it is interesting that the base period for the data did not include the time period during which the unitary method was in effect; and even if the time period had been inclusive, the criteria used by Alexander Grant & Company does not, basically, even include the unitary method as a positive or negative factor.

Further, I might add that Associated Industries of Florida and the other members of the Conference of State Manufacturers Associations (COSMA) endorsed the Alexander Grant study for a number of years but dropped our endorsement last year, primarily over the concern that criteria utilized in the study are not those that are really relied upon by business leaders when making comparisons among the various States as to the attractiveness of business climates.

[Whereupon, at 12:58 p.m., the subcommittee adjourned, subject to call of the Chair.]

APPENDIX

COMMISSIONERS:
LARRY G. LOONEY, CHAIRMAN
CAROL M. DICK
MORGAN MUNGER
DARWIN L. YOUNG



STATE OF IDAHO

DEPARTMENT OF REVENUE AND TAXATION STATE TAX COMMISSION

700 West State St. - P.O. Box 36 - Boise, Idaho 83722

334-4560

September 14, 1984

Senator Charles Mathias
Chairman, Subcommittee on
International Economic Policy
440 Dirksen Senate Office Building
Washington, DC 20510

RE: Hearing September 20--Worldwide Unitary Taxation

Dear Senator Mathias:

Idaho is one of the states which actively applies the worldwide combined reporting method for determining the source of income for state income tax purposes. We in Idaho have continuously voiced our opposition to any federal restrictions on the authority of states to require unitary combined reports from multinational corporate taxpayers. Please enter this letter and its attachment into the record of your subcommittee's September 20, 1984, hearing as our statement opposing federal restrictions on state taxation of multinational corporations.

The attached position paper explains the beliefs of the Idaho State Tax Commission. We believe the unitary method to be superior to any available alternative method for determining the geographical source of income. We further believe most of the vigorous opposition to the unitary method is not based upon the legal, equitable or practical objections commonly voiced by opponents. Instead, our experience leads us to believe that opposition is motivated by the fact that the unitary method allows few opportunities to reduce state taxes by shifting or eliminating taxable income. We support worldwide unitary reporting because it offers the following major advantages.

1. Unitary apportionment is evenhanded to all taxpayers. Income is attributed to the taxing state based upon the actual amount of activity in the state, not upon arbitrary accounting rules. Principles of accounting, even as modified for tax reporting purposes, were never designed for the purpose of attributing income to a geographical source. The three-factor formula used in

(379)

conjunction with the combined report directly links income with the actual amount of economic activity occurring in the taxing state. No practical available alternative accomplishes this result.

2. The unitary method ensures full accountability of all taxable income wherever earned if the method is uniformly applied. Because income is allocated based upon activity and all activity is identified and accounted for, there can be no underreporting or overreporting of income to all of the jurisdictions within which the unitary business activities are conducted. Thus, a multicorporate taxpayer will be subject to tax upon 100 percent of its income--neither more or less.

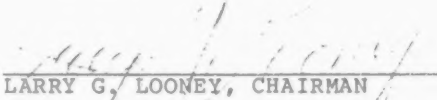
3. The unitary reporting method possesses the virtue of simplicity. Opponents of unitary reporting often complain that it is administratively burdensome. However, compared to the burdens imposed in any attempt to effectively enforce available alternatives, unitary reporting is actually simpler. Excluding corporations from a unitary report requires that intercompany transactions occurring between included and excluded corporations must be analyzed on a transaction by transaction basis to determine that they actually reflect arm's length pricing levels. Arm's length adjustments are contemplated under Sec. 482 of the Internal Revenue Code. This section has led to extensive, expensive and complex administrative burdens, costly litigation and serious criticism from many authorities. Applying it to state taxes would multiply the complexities.

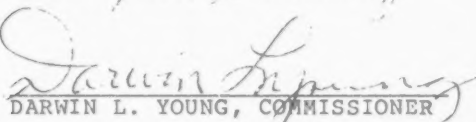
4. The unitary business method protects entirely local taxpayers who are effectively taxed by that method now. Entirely intrastate corporations cannot shelter

income from state taxation or obtain favorable state tax rates as a result of any interstate or international aspects of their business. Thus, the unitary reporting method provides a more evenhanded tax environment for all business taxpayers by treating them equally.

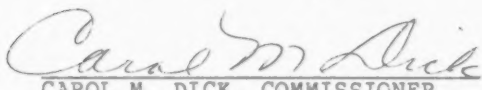
Attached to this letter is a position paper by the State Tax Commission which explains in more detail the reasons we believe unitary reporting to be fair and equitable. We urge that you not encroach upon the traditional prerogatives of the states. You should continue to allow states to develop fair and workable methods for taxing interstate business and to exercise the full power of taxation which the Constitution allows to the states.

STATE TAX COMMISSION
STATE OF IDAHO


LARRY G. LOONEY, CHAIRMAN


DARWIN L. YOUNG, COMMISSIONER


MORGAN MUNGER, COMMISSIONER


CAROL M. DICK, COMMISSIONER

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THE UNITARY BUSINESS CONCEPT
AND COMBINED REPORTING OF INCOME
FOR IDAHO TAX PURPOSES

A POSITION PAPER BY THE
IDAHO STATE TAX COMMISSION

INTRODUCTION

Idaho imposes its corporate income tax on income earned from Idaho "sources."¹ When a corporate taxpayer conducts business activity both in Idaho and elsewhere the portion of its total income which is to be attributed to Idaho--and therefore taxed by Idaho--must be determined. Making an exact calculation of income earned from business activities in Idaho is an elusive goal both in theory and in practice. The unitary business concept is a method of attributing income to Idaho.

The unitary method attributes income to a state based upon the amount of income producing activity which occurs in the state. Income is considered to be the result of three kinds of economic activity. These are: (1) use of capital; (2) Use of labor; (3) use of the market. These three activities together constitute the taxpayer's income producing activities. To the extent these three activities occur in Idaho, they are the "source" of income earned within Idaho.

The Idaho Income Tax Act applies this principle to corporate income taxes. It requires that the amount of income earned from Idaho sources be determined by measuring the amount of activity which occurs in Idaho. Activity is measured by

three identifiable factors taken from the taxpayer's accounting records. The factors are: (1) real and tangible personal property (capital), (2) payroll (labor); and, (3) sales (market). In each instance an "Idaho" factor is computed. For example, in the case of property, the Idaho property factor is the amount of real and tangible personal property used in business activity in Idaho divided by the total amount of such property the taxpayer uses in its business everywhere. If one-third of a taxpayer's property is located in Idaho, the property factor will be 33%. Similar calculations determine the taxpayer's payroll and sales factors for Idaho. These three factors are added together and divided by three. The result is the "Idaho apportionment factor" which is applied to the corporation's total net taxable income earned everywhere to compute the portion of that income earned in Idaho. In this manner, Idaho traces income to Idaho sources not by tracing the corporation's many separate business transactions (called "separate accounting") but rather by measuring its income-producing activities.

The "combined report" of income is a refinement of the unitary business principle. Stated simply, it combines all of the income resulting from the business activities of a group of commonly controlled corporations conducting a single unitary business and taxes that portion of the combined income attributable to the income producing activity occurring in Idaho. The three factor apportionment formula is used to attribute a portion of the combined corporation income to Idaho

based upon the proportionate share of property, payroll and sales of the combined group located in the state. The unitary method prevents corporations from making "paper" shifts of profits to states or countries where income taxes are low or non-existent, or from making profits disappear completely through artificial intercompany pricing. It relates and limits the amount of income taxed in Idaho to the extent of income producing activity occurring here.

A combined report is only required when a related group of corporations is engaged in a "unitary" business. A unitary business exists when the activities of the separate corporations are too closely connected and necessary to each other to justify a division or separate consideration of the activities of each. A business is unitary when the operations conducted in one state benefit or are benefitted by operations in another state and if the separate corporations are interdependent or of mutual benefit so as to form one integral business rather than several business enterprises. The test most often applied to determine if a business is unitary is the "three unities" test first articulated by the California Supreme Court. When there is a unity of ownership, a unity of operation, and a unity of use, a combined report is appropriate.

Combinations are authorized by the Idaho Income Tax Act which, in §63-3027(s), states:

For purposes of this section two (2) or more corporations the voting stock of which is more than fifty percent (50%) owned directly or indirectly by a common owner or owners may, when necessary to accurately reflect income, be considered a single corporation.

It is the combined reporting aspect of the unitary business principle which some corporate taxpayers oppose. Some taxpayers oppose the concept only insofar as the combined group may include corporations doing business in foreign countries. Some other taxpayers challenge any effort to combine commonly controlled corporations.

This paper critically examines each of the reasons asserted for limiting or prohibiting combined reports and develops the contrary argument for each reason. It also shows how the corporate tax system in Idaho would become discriminatory--to the disadvantage of Idaho domiciled taxpayers--if combined reporting is limited or prohibited.

ANALYSIS OF CRITICISM OF THE UNITARY METHOD

I.

CONTENTION: Combined reports by unitary businesses are unnecessary. The State of Idaho can adequately protect its revenue sources if it finds a taxpayer is improperly setting intercompany charges by adjusting the charges to a fair "arms-length" amount under authority of §482 of the Internal Revenue Code.

RESPONSE: Formula apportionment of all business income is the only reasonable method of determining the source of income. The "arms length" alternative is only a loophole through which millions of dollars of state revenue can escape to non-Idaho business treasuries.

DISCUSSION: It is generally accepted that separate geographical accounting for state income taxes is unworkable. Separate accounting, however detailed, cannot accurately measure income earned from activities conducted within an arbitrary geographic area like a state. The United States Supreme Court has explained the problem by saying that:²

separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required. 445 U.S., at 438 (citation omitted).

Separate geographical accounting is inaccurate for state income tax purposes because common accounting procedures are designed for purposes other than determining the geographical source of income.

While tax avoidance may enter into a [multinational corporation's] determination of transfer prices, there are many important non-income tax influences on such decisions. Whatever the motivation, however, freely established transfer pricing represents a means whereby [multinational corporation] profits produced by subsidiaries in countries with high tax burdens may be shifted to other entities subject to more favorable tax treatment. Whenever transfer pricing has the effect of shifting income in this way, a country in which economically significant activities took place is deprived of some portion of its fair share of the taxable income of the [multinational corporation].³

The "arm's length method" (i.e., adjusting intercompany charges to reflect a fair market level) is a poor alternative for measuring state income taxes. The United States General Accounting Office, in a 1981 study of IRC §482,⁴ severely criticized of the arm's length method and suggested Congress consider the use of state-developed apportionment methods on the federal level. In practice, the arm's length method is extremely complex and difficult to administer. The General Accounting Office study discovered that the Internal Revenue Service found an "arm's length" price in only 38% of the cases it reviewed. The Internal Revenue Service admits the method is difficult to administer on the federal level. Internal Revenue Code §482 regularly invites costly litigation.

These difficulties are multiplied on the state level and present extensive opportunities for manipulation and understatement of income. It has been suggested that this is the principal reason for its international popularity. Our experience has shown that it is fairly easy for taxpayers to manipulate income by structuring intercompany transactions to shift income from one company to another--thereby moving income from one jurisdiction to another as may be most advantageous to the taxpayer without any real change in the real economic activity occurring within or without a particular state. For example, a parent corporation may charge a management service fee to its subsidiary. If the fee is high, the subsidiary's taxable income will be reduced while the parent's taxable income is correspondingly increased. Because of the very

uniqueness of the parent's management skill, it is, by any practicable standard, impossible to place an open market "arm's length" value on the service in order to determine if the amount charged to the subsidiary is fair. The same is true for the whole range of intercompany charges. The very number of such charges by itself places an impossible burden on the state tax authority which seeks to police them.

The difficulty of administering the arm's length method is amply illustrated by the recent accounts about the Marc Rich Company widely reported in the financial news media.⁵ According to these reports, Marc Rich is alleged to have evaded federal taxes on more than \$100 million of income. Profits made on sales of crude oil by an American subsidiary corporation were channeled to the Swiss parent corporation by means of intercompany sales prices which insured that the American companies experienced substantial losses. The massive federal tax evasion alleged to have occurred could not happen if the unitary tax method had applied to the transactions described in the news media.

Some have suggested that states should be allowed to use arm's length transaction data developed by the Internal Revenue Service to aid in enforcement of state taxes. Federal information is now available to states under the information exchange authorized by the Internal Revenue Code. By itself, this information is insufficient for state purposes. Transactions which have no relevance for federal purposes because they only move income from one state to another may

result in massive understatements of state taxes. Additionally, limiting the states to only data developed by the Internal Revenue Service would deprive the states of the ability to independently verify its correctness or to supplement the information as it may apply to issues peculiar to state taxation. (For example, the "throwback sales" provisions of the Uniform Division of Income for Tax Purposes Act). Currently the IRS collects no information on interstate pricing. Its §482 analysis is primarily applied to international, not interstate, transactions. Requiring the states to rely solely on Internal Revenue Service developed arm's length data would greatly cripple state enforcement under either the unitary or the arm's length method.

II.

CONTENTION: The unitary method results in taxation of income earned in other states and foreign countries. Because those states and countries also tax the income, the result is double taxation.

RESPONSE: It is a fundamental proposition of constitutional law that a state cannot extend its taxing jurisdiction to include more income than is fairly attributable to the business activities conducted within its borders. This avoids any double taxation resulting from a state's use of the unitary method.

DISCUSSION: Federal and state courts addressing the issue have not found that the unitary method of computing state taxable income results in an extraterritorial reach by a taxing

state. If a particular state's application of the unitary principle or its application to a particular taxpayer actually results in an overstatement of taxable income, the courts have adequately protected taxpayers' rights. Because there are constitutional safeguards against a state's taxing more income than can be fairly attributed to that state, no statutory safeguard to achieve the same end is needed.

Nor is there reasonable support asserting that taxpayers are experiencing double taxation. So long as Idaho taxes only income which is fairly attributable to activities in Idaho, any double taxation is not the result of Idaho's tax laws. In a recent decision relating to California's taxation of Container Corporation of America,⁶ the United States Supreme Court rejected the taxpayer's allegation that the unitary method necessarily results in double taxation. We know of no case in which a taxpayer has proven to the satisfaction of a court that application of worldwide unitary reporting was the cause of any impermissible double taxation. The real problem is lack of full accountability for all income earned by a taxpayer in the course of its business operations.

III.

CONTENTION: Insofar as a state's combined reporting requirements include corporations doing business in foreign countries, the state using the unitary method is violating internationally set standards of taxation.

RESPONSE: The idea that the "arm's length" rule is an accepted international standard is a myth. But even to the extent that such a standard exists, international standards applicable to income taxes at a national level have never been required for American state taxes, unless federal law or treaties expressly require it.

DISCUSSION: There is no evidence that a majority of nations conform to a uniform standard of "arm's length" accounting. Moreover, no established international standard prevails, "arm's length" or otherwise, to determine what constitutes foreign source income. And finally, what international sourcing practices are employed do not prohibit use of the unitary method.

The phrase "arm's length" does not appear in any tax treaty or in the internal laws of any nation, but it is commonly used to refer to a method of adjusting the separate accounting of transactions between related entities to reflect what the accounting would have been like if the transactions had been between unrelated entities. The United States is the only country which, through regulations to I.R.C. Section 482, has promulgated detailed, comprehensive administrative guidelines for the application of its definition of the "arm's length" test.

Only 37 countries of 171 (22 percent) have bilateral tax treaties with the United States which contain any sort of "arm's length" language. Even where such language does exist, each nation administers this language in a different manner to

be compatible with that nation's internal tax laws. The U.S. Supreme Court, in its June 27, 1983, decision in the Container Corporation case, recognized the lack of uniformity in application of the "arm's length" method. The Court noted, ". . . A serious problem . . . is that even though most countries have adopted the arm's length approach in its general outlines, the precise rules under which they reallocate income among affiliated corporations often differ substantially . . ."

Among the minority of nations that even claim to recognize the "arm's length" method, tax authorities assert their own interpretations of "arm's length" dealings, based on their different definitions, rules and classifications of income subject to adjustment. The combined effect of all these different approaches and definitions is to preclude any possibility of uniformity.

The only attempt to impose these putative international standards of income taxation to U.S. states was a clause the United Kingdom attempted to negotiate into the U.S.-U.K. Tax Treaty. The United States Senate refused to ratify the treaty until the offending clause was removed. Similarly, legislation restricting the state's power to apply the unitary method on a worldwide basis has been introduced in every recent session of Congress but has made little progress. Both Senator McClure and Senator Symms of Idaho have joined with other members of the Senate and have expressed their opposition to these bills and referred to the "fairness" of the unitary method. Clearly, to the extent that there is an established norm for states to

follow, it is to allow states to deviate from the arm's length transaction standard.

IV.

CONTENTION: States' application of the unitary tax method impedes the free flow of international commerce, foreign investment and technology exchange.

RESPONSE: Fears that use of the unitary method by the states of the United States may adversely affect foreign commerce are ungrounded.

DISCUSSION: The unitary concept was first applied to income taxes in California in the 1930's and is now used, at least to some extent, by most states which impose a net income tax. Despite this extensive growth of the unitary method by states, a 1983 study by the Advisory Commission on Intergovernmental Relations⁷ concluded there has been no loss of foreign investment in the United States, no refusal by foreign governments to conclude tax treaties with the United States, and no retaliatory taxation. Restricting or prohibiting the use of the unitary method would in fact have the effect of sheltering foreign investors in Idaho against state taxation at the same effective rate that domestic taxpayers must bear. This would provide foreign businesses a competitive advantage over our own all-Idaho small businesses who cannot take advantage of tax shelters afforded by the intricacies of international commerce.

V.

CONTENTION: The unitary business method imposes serious accounting hardships.

RESPONSE: Any method of determining the source of income by state is necessarily complicated. The unitary concept is actually simpler than any available alternative.

DISCUSSION: Corporations whose shares are publicly traded are already required to submit accounting reports to the Securities Exchange Commission on a consolidated basis. While tax accounting and book accounting may differ, the conversion to tax accounting is greatly simplified by the fact that consolidated figures already exist in Securities Exchange Commission reports. Ironically, the alternative to the unitary combined report is far more burdensome both to taxpayers and tax administrators. Detailed auditing applying the concepts of the "arm's length" provisions of Internal Revenue Code §482 is far more difficult, time consuming and expensive than auditing a unitary combined report. In the past, taxpayers have been spared this burden both by the inadequate staffing of most state tax authorities and by the states' choice to use the unitary method. Prohibiting or limiting the states' use of the unitary report would force states to rely more heavily on burdensome §482-type audits in order to protect their revenue sources. We believe some taxpayers have incurred more cost litigating against and resisting compliance with the unitary system than would have been incurred by complying in the first instance.

VI.

CONTENTION: President Reagan has encouraged the removal of obstacles to good international relations in commercial affairs. The states' use of the unitary method on a worldwide basis is objectionable to foreign business and therefore should be prohibited in the spirit of international cooperation.

RESPONSE: President Reagan's policy has not extended to opposing the states' use of the unitary method for state income taxes.

DISCUSSION: The President has directed his administration to take no position on pending bills in Congress which would limit state's authority to use the method. Despite widespread pressure from the international business community, the President prevented his Solicitor General from filing an amicus brief in the Container case opposing the states' position. As governor of California--a state which, like Idaho, actively applies the unitary concept--President Reagan supported unitary taxation. The President has appointed a cabinet level task force, headed by Treasury Secretary Donald Regan, to do a comprehensive study of the issue with particular emphasis on its effect on international commerce. The task force includes representatives from the international business community, the states and the federal government. The Secretary has indicated he intends the task force to complete its deliberations "with deliberate speed." The purpose of this group is to formulate recommendations for the President. At the date of this writing (December 14, 1983) the task force has already decided not to

propose preemptive federal legislation on this subject, and to limit its discussions to international applications.

VII.

CONTENTION: The unitary tax method unfairly burdens businesses engaged in interstate and international commerce.

RESPONSE: Exactly the opposite is true. Prohibiting a state tax agency from requiring a combined report of income creates unfair and discriminatory burdens on taxpayers whose business is mostly local.

DISCUSSION: Restricting the states' authority to require a combined unitary report of income would result in understatement of income to Idaho. We would be unable to impose our income tax upon the full amount of income which has already been judicially determined to be income fairly attributable to Idaho. The effect is that those multistate and multinational taxpayers benefitting from the restriction would pay taxes at a lower effective rate than our own mostly local businesses. The result would be to discriminate against entirely local businesses in favor of allowing large multistate and multinational operations to reduce their taxes. This benefit to large corporations must be compensated, at least in part, by individual and small business taxpayers not large enough to benefit from the overseas investment any restrictive legislation will invite.

Additionally, tax policies that benefit only non-Idaho investors encourage control of Idaho's resources by boards of directors which are remote and removed from Idaho. If Idahoans

are to have a say in Idaho's future, we should not make ourselves subordinate to the influence of corporate giants headquartered in New York, Pittsburgh, London, Amsterdam or Tokyo.

The bottom line of prohibiting or limiting the use of the unitary method of state taxation is that the integrity of state prerogatives will be seriously impaired. The state will lose a significant amount of revenue which will have to be replaced by increasing the burden on smaller taxpayers. Foreign investment in and foreign control of the Idaho economy would be sheltered and thus encouraged. An equitable and uniform method of determining corporate income will be denied to Idaho. Only multinational corporations will benefit from the legislation.

The National Small Business Association has testified to the U.S. Treasury Department's working group on the unitary tax method opposing restrictions on the states. The Association's representative, Mr. Jere Glover, said:

Most states have always applied the unitary method to small business and to businesses operating across state or national lines through branches rather than subsidiaries. Twenty-four states currently require that domestic subsidiaries be included in tax returns filed by corporate taxpayers. Of these, 12 also require that foreign subsidiaries be included. By closing the "subsidiary loophole," these states have increased their corporate income tax revenues from 3% to 60%, without raising their corporate income tax rates. For example, California estimates that the inclusion of foreign subsidiaries in a corporate tax return generates \$500 million in addition to what is collected from including domestic subsidiaries in a corporate tax return.

Unlike large firms, most small businesses are located primarily in one state. Even when they operate across state lines, they rarely can use the subsidiary loophole. When multinational corporations, using sophisticated accounting manipulations, are able to transfer their tax liabilities outside a particular state, the remaining domestic firms -- the small businesses that create most new jobs -- are left to shoulder the state's financial burdens. Tax avoidance by multinationals imposes a heavy cost on small business. Every dollar of legitimate taxation large corporations are able to avoid must be paid for by other taxpayers. For example, the year after Illinois repealed its application of the unitary method to multinationals operating through subsidiaries, the corporate tax rate was increased from 4% to 4.8%. After giving a big tax break to the multinationals, the State made small business pick up the tab. Likewise, Governor Bob Graham of Florida has said that if recently enacted legislation requiring the evenhanded use of the unitary method is repealed, the State will have to raise its general corporate profits tax from 5% to 6%. Again, small business would have to pay higher state taxes so multinationals could pay lower ones.

Study after study has documented that small business is responsible for creating the majority of new jobs in our economy. Yet, once again, consideration is being given to putting small business at a competitive disadvantage. Some proponents of federal restrictions on state taxation of multinationals claim that lowering their tax will promote investment and job creation. In fact, the reverse is true. Even if we assume that some multinationals will cut back the activity in states that apply the unitary method even-handedly, there are more than enough entrepreneurs and smaller firms ready to fill the gap. Where there is a market, a resource, or a skilled labor force, small business will make the investment and create the jobs if multinationals refuse to without a special tax subsidy. Indeed, by artificially subsidizing uneconomic spending by

multinationals, restrictions on the unitary method will diminish aggregate investment in the United States.

VIII.

CONTENTION: Repeal of the unitary method would encourage new investment and business growth in the state.

RESPONSE: This contention is defective in two ways. First, to the extent that tax incentives are used to stimulate a states' economy, the incentives should be equally available to smaller in-state businesses not just to large out-of-state and foreign businesses. Second, there is no real evidence that state tax incentives actually work.

DISCUSSION: If tax incentives are to be used as tools for stimulating the state's economy, the tax policies adopted should provide incentives available to all businesses in the state. For the reasons explained more fully in part VII, limiting or prohibiting Idaho's use of the unitary business method would be beneficial only to large out-of-state and foreign corporate organizations. Smaller Idaho businesses--the ones who provide most jobs--would receive no benefits. Such a discriminatory system of tax incentives is blatantly unfair.

Moreover, there is virtually no empirical research supporting the claim that tax incentives actually work. Objective research tends to indicate the contrary. The Counsel of State Planning Agencies has published a comprehensive study of all major research projects attempting to examine the effectiveness of state tax incentives.⁸ This study makes a

detailed analysis of all major recent research efforts and reaches the following conclusions:

A substantial amount of progress has been made in the research reported in this chapter toward resolving some of the issues surrounding the value of state tax incentives. While methodological problems dictate that caution is required in interpreting the results, the most important conclusions of the research include the following:

The initial foregone revenues for states, taken as a whole, are substantial, and deserving of evaluation.

Most firms making new investments do not even consider locating in any state other than their final choice.

Most firms making new investments in states with tax incentives are unaware that the incentives exist.

Only a very small proportion of firms making investments claim that they would have located in another state in the absence of tax incentives.

In most industries, the general level of business taxation has an undetectable effect on investment patterns.

In those industries where an effect can be detected, it is quite small.

When evaluated as a public investment, specific tax incentives may have an acceptable rate of return, particularly if targeted to areas of high unemployment and unused public infrastructure.

Overall business tax reductions, even if targeted to sensitive industries, do not appear to be acceptable state tax policy for stimulating investment.

* * *

The preceding remarks should not be interpreted as support for the provision of

tax incentives. To the contrary, in many ways the provision of tax incentives represents a significant obstacle to sound development policy. Even if tax incentives are a good public investment, meeting the conditions discussed in Chapter Four, they will influence only a tiny proportion of new investment in any state. While the evidence is unclear about whether or not targeted incentives are a good policy, it is unequivocal about whether or not incentives are a significant policy. They are not. The evidence provides little support for those who believe that poor states, or stagnating states, can stimulate their economies in any significant way by a heavy reliance on either targeted tax incentives or across the board reductions in business taxes. Even where the evidence indicates that incentives are potentially a good public investment, they could be eliminated with almost an unnoticeable effect on a state's economy. In contrast, if the amount of time state legislatures spend debating tax incentives and the effect of taxes on investment was redirected toward other areas, substantial progress might be made. Tax incentives are clearly not a substitute for state initiatives in labor markets, capital markets, transportation, regulation, and the quality of life. Too often it is easier to pass a tax incentive, and widely advertise it, than to deal with more fundamental problems. To ignore the problems and factors which influence the great majority of investment decisions is to doom a state's development policy to marginal influence. [Emphasis in original]

CONCLUSION

The unitary principle has been developed over many years and is approaching the point where multinationals are taxed on the income they earn from their activities in Idaho, no more and no less. Idaho, through its membership in the Multistate Tax Commission and other organizations, is committed to the goal of uniform apportionment of income for state tax

purposes. Lack of uniformity among income tax states is a matter of legitimate concern. We believe the states have made substantial progress toward uniformity in the application of the unitary method. Guidance provided in recent decisions of the United States Supreme Court will assist Idaho and other states in our efforts to improve the administration of the unitary method. We do not believe that the goal of equity in state income taxation can be achieved by affording broad and discriminatory loopholes to a limited group of multinational taxpayers.

- 1 Idaho Code §63-3025A
- 2 Container Corp. of America v. Franchise Tax Board, ___ U.S. ___, 103 S.Ct. 2933 (June 27, 1983)
- 3 "Multinational Corporations and Income Allocation under Section 482 of the Internal Revenue Code" 89 Harvard Law Review 1203 - 1204 (1976)
- 4 The Comptroller General of the United States, Report to the chairman of the House Committee on Ways and Means, IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (GGD-81-81), Washington, D.C., U.S. General Accounting Office, September 30, 1981.
- 5 Barron's, September 19, 1983, page 8
- 6 See note 2.
- 7 "State Taxation of Multinational Corporations" Advisory Commission on Intergovernmental Relations, Report A-92, April, 1983.
- 8 Michael Kieschnick, Taxes and Growth, Business Incentives and Economic Development, Council of State Planning Agencies, 1981.



MINNESOTA TAX STUDY COMMISSION
400 NORTH ROBERT STREET
SUITE 920
ST. PAUL, MINNESOTA 55101
612-297-1133

October 8, 1984

Senator Charles Mathias
 Chairman, Subcommittee on
 International Economic Policy
 440 Dirksen Senate Office Bldg.
 Washington, D.C. 20510

Re: Statement for the Record, Worldwide Unitary

Dear Senator Mathias:

I am enclosing a copy of a recent report that was prepared for the State of Minnesota relating to worldwide unitary apportionment. This statement, which was prepared for the Governor's Tax Study Commission, is designed to present an evenhanded treatment of the controversy.

The sixteen member Minnesota Tax Study Commission will be making its recommendations on unitary apportionment to the Governor and the Legislature on December 15, 1984.

Sincerely,

Robert D. Ebel

enclosure

WORLDWIDE UNITARY FORMULA APPORTIONMENT

A Background Paper Prepared For
The Minnesota Tax Study Commission

EXECUTIVE SUMMARY

Both the separate accounting and worldwide unitary formula apportionment approaches to determine state corporate income tax bases attempt to attribute source income. Both also have numerous difficulties and elements of imprecision, and there is little in the way of systematic evidence with which to compare the two methods. This lack of systematic evidence appears to complicate the controversy regarding the arguments for and against Federal intervention in state business tax policy.

Despite these problems, there is information to permit one to make an informed judgment regarding the relative merits of the two approaches. To summarize:

- The constitutionality of whether the states may apply worldwide formula apportionment to a United States based multinational was upheld in the Supreme Court's June 1983 decision in Container Corporation of America v. Franchise Tax Board. One topic the Court did not resolve, however, was the definition of what constitutes the "unitary" nature of either a foreign or United States based multinational.
- Despite the theoretical virtues of its intended geographical neutrality, in practice the separate accounting approach is so complex that it creates enormous administrative burdens and uncertainty for taxpayers and administrators alike. The major reasons for this stem from the problems of transfer pricing and the allocation of overhead costs.

- If the Achilles' heel of separate accounting is the difficulties inherent in determining fair "arms-length prices" among inter-dependent multicorporate operations, the Achilles' heel of worldwide combination is the lack of agreement on what constitutes a "unitary" operation.
- At present, 13 states use the worldwide combination approach to corporate income taxation; however, only two - Alaska and California, - can be said to vigorously pursue foreign based multinationals. As a practical matter, it is the tax status of the United States owned multinational that is at the heart of the debate.
- States would lose some of the potential tax base they claim if they were forced to use some method of separate accounting at waters edge rather than worldwide unitary apportionment. One estimate is that the difference between book and apportioned profits is about 15 percent. This gap lends support to the arguments of tax administrators that some multinationals (particularly petroleum and coal companies) are engaging in various transfer pricing techniques to avoid paying taxes in high tax states.
- On the basis of existing evidence, the multiple taxation argument favors neither opponents or proponents of federal restrictions on state business tax methods.
- When one considers the available evidence regarding what determines business investment and location decisions among states in conjunction with the small quantitative impact on total business tax costs that are generated by worldwide combination, arguments that formula apportionment provides a significant disincentive to foreign investment in the United States are not convincing.
- The states' use of worldwide unitary taxation frustrates the goal of achieving tax harmonization among nations. Just how this "cost" of fiscal federalism will lead to difficulties in United States foreign policy matters is not certain.

I. Introduction

The purpose of this paper is to present in an evenhanded manner the arguments and evidence that pertain to the states' use of the worldwide unitary method of measuring the state corporate income tax base. Although the issue is not a new one (see Exhibit 1), it has become particularly heated as a result of the June 1983 decision of the United States Supreme Court (Container Corporation of America v. Franchise Tax Board). In its ruling, the Court upheld California's use of the worldwide unitary method of computing the total taxable corporate net income of a United States multinational but, at the same time, made it clear that Congress could curb the states' flexibility in this area if it wished.

The heated nature of the present controversy is in large part due to the fact that there is little systematic empirical evidence on the specific topics of debate. The issue is complex, involving legitimate disagreements among the debating parties. This complexity and diversity of opinion does not mean, however, that an informed judgment of the merits of worldwide combination cannot be made.

The discussion below begins with a presentation of the basic nature of the controversy and then is followed by a more detailed discussion and evaluation of the specific issues that are the heart of the controversy. Although the focus is on the choice of separate accounting vs. worldwide unitary apportionment, many of the arguments that are made here apply to the separate accounting-unitary domestic worldwide combination generally.*

* Part of the controversy, the taxation of foreign source dividends, is not discussed. At present, Minnesota excludes all foreign source dividends from state taxation.

EXHIBIT 1HIGHLIGHTS OF WORLDWIDE UNITARY APPORTIONMENT DEVELOPMENTS

- 1957 Uniform Division of Income For Tax Purposes.
The National Conference of Commissioners on Uniform State Laws proposed the Uniform Division of Income For Tax Purposes Act (UDITPA) dealing with the allocation or apportionment of multistate business income. UDITPA, which the states are free to adopt or ignore, requires an equally weighted three factor formula consisting of payroll, property, and sales.
- 1959 Northwestern v. Minnesota.
The U.S. Supreme Court ruled in Northwestern States Portland Cement Company v. Minnesota that a state could impose an income tax on a nondomiciliary engaged solely in interstate commerce within that state. Specifically, Minnesota was upheld in its taxation of an Iowa corporation engaged in the regular and systematic solicitation of sales orders in Minnesota. The Company maintained a sales office in Minnesota; however, all orders were filled from outside the state.
- 1959 Within seven (7) weeks of Northwestern, the U.S. Senate Select Committee on Small Business began a series of public hearings and followed with a report to the full Senate urging (a) a Federal statute establishing a minimum standard (nexus) for the imposition of state income taxes and (b) the creation of a study commission to formulate uniform standards.
- 1959 On August 8, for the first time Congress exercised its power over interstate commerce to enact a general statute dealing with state taxation of interstate business. Public law 82-272 specified a minimum jurisdictional standard for state taxation (precluding taxation if the only activity were solicitation of orders or using an independent contractor to make sales within the state).
- 1960 In Scripto, Inc. v. Carson, the Supreme Court held that a state could collect a use tax on sales made within the taxing state even though it maintained no facilities within the state and its sales were made through independent contractors.
- 1960 Reluctant to further restrict the states without thorough study, Congress established the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary.

- 1964 The Special Subcommittee released a four volume study (the "Willis Report," named for its chairman, Edwin Willis), the State Taxation of Interstate Commerce. The report stated that "In keeping with the basic structure of our federal system, the Committee is of the view that international tax policy should be formulated by the federal government, not the individual states." However, no action was taken and no rules were prescribed.
- 1967 A group of states reacted to the possibility of Federal legislation, which would require greater uniformity in apportionment, by adopting a multi-state compact and establishing the Multistate Tax Commission, which over the years has established uniform income tax regulations and rules regarding the allocation and apportionment of State corporate income. However, the states have not fully agreed to these regulations and rules; thus, the method of interstate taxation of corporations still varies among the states.
- 1973 The Senate Finance Committee established a Subcommittee on State Taxation of Interstate Commerce. Subcommittee Chairman Walter Mondale (D-Minn) cited almost total lack of agreement between states and business interests and recommended negotiations be held through 1974-75.
- 1975-77 The Task Force on Foreign Source Income, chaired by Rep. Dan Rostenkowski (D-Ill) recommended a bill that prohibited states from using worldwide combination accounting for apportioning income from foreign sources. Bills to accomplish this were introduced in 1977 by Rep. Bill Frenzel (R-Minn), Barber Conable, Jr. (R-NY) and James Jones (D-Okla) and by Senators Charles Mathias (D-MD) and Abraham Ribicoff (D-Conn).
- 1977-84 Senator Mathias and Rep. Conable have kept legislation alive that would abolish worldwide unitary.
- 1978 The issue heated up between the states and business interests when the U.S. Senate deleted from a U.S.-U.K. treaty a provision which would have prohibited the states from using worldwide combinations. Although this provision applied only to U.K. firms, states saw it as the first step in total abolition. The major players in the debate have been the Committee on State Taxation (COST) of the Council of State Chambers of Commerce vs. the Multistate Tax Commission and the National Governors' Association.

- 1983 The U.S. Supreme Court ruled in Container Corporation of America v. Franchise Tax Board that California could claim that Container Corp., a U.S. resident, and its 20 foreign subsidiaries were a "unitary business" and as such was entirely within reach of state taxing authority. The Court further held that California's apportionment formula, a typical one based on the share of corporate payroll, sales and property in the state, fairly assigned a reasonable portion of combined international income to California.
- 1983 Following Container, the Florida legislature adopted worldwide unitary with respect to U.S. parents and their affiliates.
- 1983 Minnesota becomes the 21st state to join the Multistate Tax Commission.
- September 1983 - July 1984 In September 1983, President Reagan formed a Unitary Tax Working Group to study the complex issues raised by the states' use of worldwide combinations. Last month (July 31) the working group released a report noting agreement that state tax policy should include two principles: water's edge combination for both U.S. and foreign based corporations, and increased federal assistance and cooperation with the states to promote full taxpayer disclosure and accountability. The group failed to agree on the proper tax treatment of foreign dividends paid to U.S. corporations (these are exempt in Minnesota) and corporations with primarily foreign operations (80/20 corporations).
- July 1984 Treasury Secretary Regan stated he would recommend federal legislation to prohibit worldwide unitary if the states had not shown progress toward adopting these principles by July 31, 1985.
- August 1984 The Multistate Tax Commission released a statement saying that the threat of federal legislation broke faith with the states' understanding that restrictive federal legislation was ruled out.
- August 1984 Oregon repealed the authority of the State to require or permit worldwide combined reporting.

II. Measuring The Tax Base: Separate Accounting vs. Unitary Method

The controversy pertains to how a state should measure the tax base of a multinational corporation that has part of its business operations carried out within that state's boundaries. There are two basic approaches - the separate accounting and the unitary combination with formula apportionment. Each approach attempts to attribute only "source income" to the taxing state.

Under the separate accounting approach, a multinational parent corporation and its affiliates are each treated as having separate and legal economic status for state and national tax purposes. This requires that (a) each multinational keeps books on an affiliate-by-affiliate basis; (b) intercompany transactions (e.g., between the extractive, manufacturing and marketing divisions) be adjusted as if made on arms length basis; and (c) the profit and loss of each affiliate be deemed as an event independent of the corporate whole. Thus, for example, if transactions occur between related foreign and domestic corporations, the income attributable to the foreign entity is calculated as if it results from transactions between independent parties. One practical feature of this approach, which is particularly relevant to the present debate, is that it conforms to internationally accepted standards for taxing foreign owned enterprises operating within the United States and U.S. owned enterprises operating abroad. Thus, by forcing the states to adopt this method of tax base measurement - at least as it applies to corporate activities beyond United States political boundaries ("water's edge") - one would advance the goal of "tax harmonization," the coordination of the tax systems of various countries. This would minimize the theoretical likelihood of multiple taxation of income and resulting loss of international investment and income flows.¹

The worldwide unitary combination approach applies the same logic to the international sphere that most states now apply (and with no controversy) in the domestic sphere - they treat the multinational's parent and its affiliates as a single or "unitary" operation that for reasons of legal and management convenience are divided into separate subsidiaries. The states then apply formula apportionment to the total (see below). Thus, the unitary base, when properly defined, cuts across the legal arrangements of corporate charter making and treats interdependent business operations as a whole. This has the merit in recognizing that the multicorporate entities can maximize worldwide income by dividing their basic operations among affiliates in order to take advantages of such factors as net economies of scale, quantity purchasing operations, central advertising, ready access to capital markets and differences in factor prices (e.g., labor) among various jurisdictions. One obvious result is that a unitary business that conducts some of its operations in a state in which it suffers losses but which is profitable as an overall enterprise conducted in various states or countries may, nevertheless, pay income tax to the loss state.

As it applies to multinationals, the unitary method has three basic variants:

- Domestic Combination: the unitary method is adopted but excludes all income generated by affiliates (but not branch operations) beyond United States boundaries from the total tax base. This is the approach that Minnesota employs.
- "Waters Edge": The scope of a unitary business is limited to domestic operations only. Thus, even foreign (e.g., Canada) branches of a firm operating in Minnesota would be excluded from the income base. At present, only Illinois employs "waters edge".

- Worldwide Combination: permits income generated in foreign countries to enter the total tax base calculation. With this "worldwide" approach, two further divisions can be made that pertain to the present controversy. The states can assess the worldwide income base of only a multinational with a United States parent corporation and/or assess the worldwide operations of a foreign parent multinational.

This domestic parent - foreign parent distinction is important for two reasons. First, although it is true that at present there are 14 states that presently utilize the worldwide unitary method, only two of these - Alaska and California* - vigorously pursue the foreign parent multinational. One plausible explanation why the other unitary states do not as a practical matter pursue the foreign parent firm is that they have difficulty getting the information needed to define the unitary nature of the operations. Even the Multistate Tax Commission does not at present include foreign parent multinationals in their joint audit program. The practical result is that foreign parent multinationals do not now constitute an important component of the state corporate tax base. For example, only about 3.5 percent of California's corporate tax collections comes from foreign headquartered operations.²

* Oregon used to be a third member of the list. However, on August 15, 1984, the Governor of Oregon approved a measure repealing the state's authority to require or permit an affiliated corporation that is a part of a unitary group of affiliated corporations to file a combined corporate excise (income) tax return covering the unitary operation of the group, effective for tax years beginning after 1985. The Oregon corporate excise tax is now imposed on each corporation doing business within the state measured by its federal taxable income with various adjustments.

Second, the Supreme Court's June 1983 decision addressed only the case of the domestic parent - viz, the Container Corporation of America, a Delaware corporation headquartered in Illinois. Although there is at present no distinction in state tax law between foreign and domestic parents, the Court was careful to note its decision was domestic only. At the same time, it should be acknowledged that a court test on the foreign parent case is highly unlikely in at least the near future (it took nearly a half century to constitutionally resolve the domestic parent issue).

III. Apportioning the Tax Base

The use of the unitary approach does not mean that states can tax 100 percent of a multinational's worldwide income. The unitary method is only a way to measure the firm's total tax base. Once the total base is determined, the individual state share of the worldwide base is then computed by formula apportionment. The most common formula, which the Supreme Court upheld in its June 1983 decision as a method though "imperfect" has "no evidence demonstrating that the margin of error (systematic or not) ... is greater than the margin of error (systematic or not) in separate accounting,"³ is based on an equally weighted percentage of the company's total ~~profits~~^{property}, payrolls, and sales that fall within the state.* A state that uses a net income tax and also applies this three factor apportionment formula could actually lose tax money (vis-a-vis the separate entity approach) if the company's net income were higher in-state than out-of-state. For this reason, Caterpillar Tractor Company and Zenith Radio Corporation minimized their tax bills in Illinois (at the time it applied the worldwide combination), and thus supported California in the Container controversy.

* Even if separate accounting is used at water's edge, some type of formula apportionment is still required for U.S. income.

IV. Specific Issues

As indicated above, both separate accounting and worldwide unitary formula apportionment attempt to tax state source income only. There is no hidden attempt to attach income that is beyond the legitimate interests of the state's contribution to total net income or product. At the same time, both methods are fraught with difficulties and elements of imprecision in accomplishing this task. Unfortunately, there is no objective measure with which to compare the two. This lack of systematic evidence complicates the controversy.

There is, however, evidence to permit one to make an informed policy decision regarding several identifiable topics that are part of the debate. These are summarized below.

Administrative Feasibility

ASSERTION. A major concern of the apportioning states is that despite the theoretical promise of geographical neutrality, the practical reality is that the separate accounting approach is unduly complex due to the need to construct imputed prices of goods and services transferred among affiliates and to allocate overhead costs across the multinational's operations. Generating accurate estimates of "arms-length" pricing, which is key to making separate accounting "work", can rarely be accomplished.

EVIDENCE. A key document is a 1981 study of 519 United States multinational corporations by the United States General Accounting Office (GAO) that found only three percent (3%) of the IRS' regulations for providing the taxpayer and the IRS guidance for interfirm pricing were based on a true arm's length price.⁴ The GAO concluded that administering the IRS regulations in pursuit of obtaining an arm's length price was so complex that "the process

as a whole thus creates administrative burden and a degree of uncertainty that is unacceptable for both taxpayer and examiner."⁵

There is also a clash of competing bureaucratic interests here. State tax administrators fear that without access to the unitary formula apportionment approach they cannot effectively administer state corporate laws.⁶ But the states loss may be the U.S. Treasury's gain since the Treasury would become the center of expertise on both Federal and state corporate taxation of multinationals. As one expert on fiscal federalism notes, this would make life considerably easier for Treasury and the State Department officials when they attend international tax conventions and treaty discussions.

Revenue/Tax Payment Effects

ASSERTION. If the states were disallowed both worldwide combination procedures and the ability to tax foreign source dividends as the Mathias-Conable Bills would require (Exhibit 1), the states would lose about \$700 million in revenues or about 6 percent of total state corporate tax collections (1981 data). From the corporate taxpayers' view, this means a reduced tax burden.

EVIDENCE. The \$700 million figure is based on a survey by the Multistate Tax Commission (MTC) of the 33 states that would be affected by Mathias-Conable (the reason the number is 33 rather than the 13 used earlier is due to the fact that these other states tax foreign source dividends of a multinational parent). The Committee on State Taxation (COST) of the State Chambers of Commerce does not dispute the figure, but does point out that about 70 percent of the losses are attributable to California alone (\$500 million). Thus, the COST conclusion is that the state's revenue concerns are unduly alarmist.

With so little disagreement over the size of the MTC revenue loss - tax payment estimate, why, then, does this issue play such a prominent role in the policy debate? The answer goes to the pragmatic heart of the controversy - there are more revenues to be generated (and, thus taxes to be paid) if the states are permitted to go it alone as the Container decision clearly permits them to do in the absence of Federal restrictions on their taxing powers.

The issue of just how much more revenue is at stake for United States headquartered manufacturing firms has been examined by two economists at the University of California at Davis.⁷ The numbers are not trivial:

- Dividends, even when restricted to non-business dividends, can affect the corporate tax base of an individual state by as much as 6 percent or more; and
- If the states were forced to use some method of separate accounting at water's edge rather than worldwide unitary apportionment, the difference between apportioned and book profits would be about:
 - a) 15 percent when all industries are included;
 - b) 11 percent if only oil companies are omitted from the tax base; and
 - c) 9 percent if only oil and auto companies are omitted from the tax base.

These findings lead to several conclusions:

- Although estimates are upper bound numbers (as Oregon's reversal suggests, few states would go worldwide), there are a lot of dollars at issue.

- There is a great deal of diversity among firms. It is not surprising to see corporations taking different sides in court battles over the use of worldwide combinations. COST estimates that about 10 percent of multinationals would incur reduced taxes if the worldwide combinations were applied evenhandedly.
- The lower percentages once oil is excluded suggest that this industry raises the differential between the separate accounting and unitary methods of calculating United States profits. This, in turn, lends support to the arguments of state tax administrators that the oil industry has tended to abuse the separate accounting transfer pricing gimmicks in order to shift net income from high to low tax states.
- The lower percentage once autos are excluded can be explained by the fact that that industry has been generally characterized in recent years by domestic losses combined with positive worldwide profits.

There is pragmatic controversy for both sides on the issues. The state can point to the revenue effects and the potential abuse inherent in separate accounting. But, since state revenues are taxpayer burdens, the multinationals can point to the possibility of higher taxes in the future.

Multiple Taxation

ASSERTION. Central to the opponents of the state's use of worldwide combinations is that it leads to multiple taxation of income. This only frustrates achievement of the goal of international tax harmonization and discourages investment. In its simplest context, multiple taxation refers to the fact that income generated outside the foreign affiliate will be taxed first by the foreign jurisdiction and then again subjected to concurrent taxation by one or more apportioning states, which do not allow an offsetting tax credit or deduction (as does the Federal Government for intercorporate dividends received).

EVIDENCE. Although there is no systematic evidence to reach a clear cut conclusion, there does appear to be multiple taxation of income. However, in the policy arena, the chief question that must be addressed is: what about the alternatives? The alternative - separate accounting - offers little that is helpful to resolution of the multiple tax issue.⁸ On this point the Court was quite articulate:

A serious problem, however, is that even though most nations have adopted the arms-length approach in general outlines, the precise rules under which they reallocate income among affiliated corporations often differ substantially, and whenever that difference exists the possibility of double taxation also exists. Thus ... arms-length ... might in some cases end up subjecting those corporations to more serious double taxation than would occur under formula apportionment.

On the basis of existing evidence, the multiple taxation argument favors neither the opponents or proponents of Federal intervention.

ASSERTION. If states need more revenue, they always have the option of raising rates and/or auditing separate accounting more aggressively. The advantage of expanding the state corporate tax base via the unitary method is that it is less visible than raising tax rates and also more difficult for parties to understand.

EVIDENCE. This assertion is true. But it should be noted that tax base augmentation strategies do have an important attribute for tax policy beyond political expediency. One reason that subnational governments employ a mix of tax devices as well as tax base broadening strategies is that all tax devices have inherent structural inequities and inefficiencies. A canon of state taxation is that one must avoid as much as possible employing any one tax device through rate increases to the point that these inherent structural defects become intolerable.

Effect on Investment

ASSERTION. Increased taxation resulting from the unitary method will discourage foreign investment in the United States.

EVIDENCE. For the firm making a marginal investment, any extra cost element, including state corporate taxes, can lead to a non-investment decision. But in evaluating the practical importance of the business investment - location decision, some perspective is required:

- There is a large body of evidence that states business tax levels are generally not important determinants in a firm's investment decision for at least two reasons: First, the impact of state taxes on the overall cost structure of the firm is small. This is likely to be particularly true for a multinational. For example, the California Franchise Tax Board estimates that by "losing" the Supreme Court case, Container corporation's state taxes increased by \$23,000 per year. That is less than one-tenth of 1 percent of this multinational's pre-tax net income when measured on either a worldwide or a water's edge basis. This figure is not out of line with similar results for the nation as a whole.⁹

Second, there are much more important determinants of business investment than state tax costs. Labor costs, wage levels, climate, physical infrastructure, good schools for employees' children and the like are usually the decisive considerations in siting a plant or in increasing or reducing operations in an area. When one turns attention to the issue of foreign investment in the United States, non-tax factors are even more significant. Added to the above list are foreign exchange problems, governmental regulation, quotas, and the most established of national taxes, tariffs.

- If a given state can be convinced that its business taxes do provide a disincentive to investment, it can reduce those taxes. Indeed, one of the reasons that state tax levels do play so minor a role in business location and expansion decisions is because states are always on guard against getting out of line with their neighbors. In this context, it should be noted that in addition to Oregon, New Mexico, Illinois and New York have all recently decided to not use the worldwide combination method of tax base measurement (New York still applies it to oil).
- "Losing" that marginal investment as a result of taxes may not be an undesirable result. Along with business expansion comes state and local expenditure requirements ranging from added costs of police and fire protection to, perhaps, expanding infrastructure capacity. The benefits of lower state taxes in generating investment can be outweighed by the net additions to costs.
- Finally, a distinction needs to be made between discouraging foreign investment in the United States and within a given state. As the June 1982 response by COST to a Department of the Treasury questionnaire indicates, foreign based firms that

have cited the unitary tax as a disincentive to business location or expansion in California have generally make a site decision in another state, not another country.¹⁰

The evidence does not support the argument that the states will "overuse" the worldwide combination to the extent they discourage (in a net benefit framework) foreign investment within their borders.

Single Voice in International Affairs

ASSERTION. By permitting states to use a different method of tax base measurement than is generally accepted in international tax matters, the United States government is not acting with a "single voice" vis-a-vis its trading partners. One result could be some form of tax retaliation by foreign governments.

EVIDENCE. This is not the sort of issue that is amenable to systematic economic examination. It goes beyond the expertise offered in this paper. The argument appears plausible and is an example of one "cost" of our system of fiscal Federalism.

An earlier draft of this paper was prepared for the White House Domestic Council (August 1983) and then subsequently published in The Multistate Tax Commission Review, March 1984 (Denver, CO). The author wishes to acknowledge the helpful comments of Michael Bell and Emil Sunley on the earlier draft.

1. U.S. Advisory Commission on Intergovernmental Relations, State Taxation of Multinational Corporations, Commission Report A-92 (Washington, D.C.: U.S. Government Printing Office, 1983) p. 3.
2. Steven M. Sheffrin and Jack Fulcher, "Alternative Divisions of the Tax Base: How Much Is At Stake?" A paper presented to the Hoover Conference on State Corporate Taxation, Stanford, C California, November 1982.
3. Container Corporation of America V. Franchise Tax Board, June 27, 1983, p. 22.
4. U.S. General Accounting Office, IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations, Report GGD-81-81, p. V.
5. Ibid.
6. Sheffrin and Fulcher, "Alternative Divisions," also conclude that determining "arms-length" prices would place a large administrative burden on the states.
7. Sheffrin and Fulcher, "Alternative Divisions," Table VIII.
8. Container v. Franchise Board, p. 30.
9. In 1982, the ratio of state corporate income tax liabilities to net income originating in the corporate sector (a conventionally used measure of total business costs) is .007. Data supplied by the Bureau of Economic Analysis, U.S. Department of Commerce, August 24, 1983.
10. Committee on State Taxation (COST) response to Treasury Question No. 4, June 10, 1982. Data provided by COST.



The Commonwealth of Massachusetts

HOUSE OF REPRESENTATIVES
STATE HOUSE, BOSTON 02193

8pt

October 3, 1984

Senator Charles Mathias
Chairman
Subcommittee on International Economic Policy
440 Dirksen Senate Office Building
Washington D.C. 20510

Dear Senator Mathias:

I am writing in regard to your committee's recent hearing on the issue of worldwide unitary apportionment. As a member of the Massachusetts Legislature's Joint Taxation Committee as well and the Massachusetts Special Commission on Tax Reform, I have devoted considerable attention to the issue over the past several years.

It is my conclusion that "unitary" is the best known method of corporate taxation and that its opponents have yet to demonstrate negative effects upon investment which would outweigh its merits.

I am also enclosing an article I wrote regarding current attempts to water down "unitary" in Massachusetts.

Sincerely,

A handwritten signature in cursive script that reads "Tom Gallagher".

TOM GALLAGHER
State Representative

Enclosure

[From the Boston Business Journal, July 30, 1984]

Perspective

Comment and Opinion

MassBank: Policy by horsetrading

by Tom Gallagher

Massachusetts Commissioner of Revenue Ira Jackson said in February that "Unitary is by no means perfect, but, on balance, it's the best that reasonable men and women have been able to come up with to pierce the corporate veil of complex affiliations without being forced to attempt the impractical if not the impossible task of reconstructing a series of countless complex intercorporate transactions." By dint of his position, Jackson would seem to be the Dukakis administration's foremost authority on tax policy. And back in February, he acted and was treated as such.

But that was before the MassBank deals started to be cut. Since that time an administration that prides itself on its technical expertise has ceased listening to its expert on tax policy. Instead it has made it clear that tax policy will be shaped by political horsetrading over the administration's pet project—MassBank.

Now don't get me wrong. I have nothing against the concept of MassBank. I find the goal of upkeep of ignored roads and bridges laudable. I understand the political importance of having specific taxes dedicated to the infrastructure to assure taxpayers that any new taxes would in fact be used only for infrastructure repair. And I applaud the idea that business taxes be used to fund transportation facilities so vital to the "business climate."

But, as a member of the Legislature's Taxation Committee and the Special Commission on Tax Reform, I must reject subordinating sane tax policy to some other project, no matter how worthy.

In an early attempt to build a coalition for MassBank, the administration met the High Technology Council's desire to repeal "unitary apportionment" well over half way. The administration sought to replace the current statute, which was law for over 50 years but only aggressively enforced under Governor Edward J. King, with one which eliminates foreign subsidiaries from the unit upon which corporate taxes are levied.

No known taxation system is perfect. But when it comes to fairly assessing corporate taxes, as Jackson stated above, "unitary" is way ahead of whatever method is in second place.

Although "worldwide unitary apportionment" appears to be a somewhat arcane topic, the concept is relatively simple. In any state with a corporate tax, a company must pay taxes on that share of its profits attributable to its economic activity within that state. Most states will determine that share by a method similar to Massachusetts' "three factor formula"—by ascertaining what percentage of total employment, assets and sales were within a given state, averaging them out and applying the resulting percentage to the company's total profits.

The rub comes when we deal with the subsidiaries not doing business in a given state. Any transaction between a parent company and its subsidiary must, by law, be an "arm's-length" transaction. In other words they cannot give each other favored treatment in order to shelter profits in a state with a lower rate of corporate taxation.

That's the law. But is it adhered to, or, in fact, are the company's accountants continually engaging in a "creative accounting" for the purpose of minimizing taxes? Answering this question is an auditing nightmare that requires chasing a paper trail of innumerable in-house transactions which end by profits showing up in no-tax or low tax jurisdictions. It is for this reason that states adopt "unitary apportionment" as the preferred, modern and business-like method of dealing with corporate taxation. It is this method that the administration seeks to undermine by eliminating at least two-thirds of the affected profits.

The effect of "unitary" upon a particular corporation is not obvious at first glance. Some corporations without state or foreign subsidiaries that lose money will pay fewer taxes. Most, with profitable subsidiaries, will pay more.

But the most important point is that with a weakened unitary corporations would have the opportunity or temptation to avoid taxes on their entire profit. In other words, they would not be taxed on the same basis as smaller businesses that operate entirely within Massachusetts. That is why the National Federation of Independent Business has opposed the administration's proposal to water down "unitary": the tax burden shifts onto those who cannot shelter profits.

Another less-known aspect of tax policy contained in MassBank is the extension until the end of 1988 of the 3 percent investment tax credit due to expire at the end of 1985. The investment tax credit is an example of what some call "tax expenditures"—potential revenue forgone by statutory exemption that serves a presumably beneficial public purpose.

Last year a law was enacted requiring the administration to produce a "tax expenditure budget"—a listing of such loopholes—as a means to begin to examine their extent and effectiveness.

And yet before the administration had produced the first such listing, it had proposed as part of the MassBank deal an extension of one of the major "tax expenditures" for three years.

The Dukakis administration is understandably interested in getting along with the other powers that be more than it did in the first term. But one has to wonder if they aren't carrying things too far when they choose to ignore both their own experts and sane and balanced tax policy in seeking to enact their pet projects.

Tom Gallagher is a state representative from Allston.

STATEMENT OF

J. THOMAS JOHNSON

DIRECTOR
ILLINOIS DEPARTMENT OF REVENUE

Submitted for the Record
Hearing Held
September 20, 1984

Senate Committee on Foreign Relations
Subcommittee on International Economic Policy
Worldwide Unitary Taxation Working Group Report

Thank you for the opportunity to comment on the Worldwide Unitary Taxation Working Group Report. The Working Group Report provides a sound solution to the problems faced by states which use the worldwide unitary tax method. It recommends that those states adopt one of five types of a water's edge approach, and it proposes that the federal government will provide limited assistance and an incentive to encourage the states to stay within this guideline.

Although the Group did not agree on a single best solution, it is not time to abandon the process or warn that it may be cut short. Instead, this is an example of fiscal federalism which should be encouraged.

Oregon and Indiana have already taken action to show that they are not worldwide unitary states, and there has been recent legislative activity in California and Florida. Illinois believes restrictive federal legislation is inappropriate now and will be unnecessary in the future.

It appears that there are members of the business community who think that federal pre-emption is the only acceptable solution. However, it also appears that their reasons are not based on a dislike of the worldwide unitary method but rather on the taxation of foreign dividends and the inclusion of 80/20 corporations within the water's edge.

These objections overlook the purpose of the Working Group. The Group was asked to address the concerns of our foreign trading partners over the states' use of the worldwide unitary method, and it did that. The Group was not asked to recommend what income should or should not be in a state's tax base. These decisions should be determined on a state-by-state basis, and that is exactly what the Working Group Report recommends.

Although there are many reasons why a state would want to tax foreign dividends and include 80/20 corporations in the unitary group, there are as many reasons why a state should not.

In 1982, largely in response to the Illinois Supreme Court's decision involving Caterpillar Tractor Company, the Illinois General Assembly abolished the use of combined reporting in Illinois. When the bill was sent to Governor Thompson for consideration, he surveyed business attitudes, studied the economic impact, and considered the tax policy issues. The Governor amendatorily vetoed the bill to provide for domestic combination with an exclusion for 80/20 corporations, a deduction for foreign dividends, and a definition of a unitary business. We in Illinois feel that this was sound tax and economic policy, and that it will create an incentive for business investment in Illinois. Ultimately, business investment will produce jobs -- the key ingredient to the fiscal health of all states.

The unique feature of this water's edge approach is the 80/20 rule. It excludes any corporation, domestic or foreign, if 80 per cent or more of its property and payroll is located outside of the United States. This means that only those companies which operate primarily in the United States can be

included in a unitary group. I should point out that this rule is not the same as the rule in the Internal Revenue Code which creates a class of corporations that receive more than 80 per cent of their income from foreign sources. It is easy to confuse these two rules. However, they represent fundamental differences in approach.

The Working Group Report also addresses federal action. Some of the recommendations of the Group are legislative and others are administrative. However, they are all designed to provide the assistance, encouragement and cooperation which will accompany the changes made by the state legislatures. Probably the two most important features are the law to require the filing of the 50 state accountability spreadsheet and the increase in IRS audit activity.

The 50 state spreadsheet, or the "domestic disclosure spreadsheet," would summarize the information which appears on the state tax returns filed by potential members of a water's edge group, and it would provide a method for reconciling differences in reporting which are required by variations in state law. The spreadsheet is solely for the use of states which confine their tax reach to the water's edge concept. The benefit of this spreadsheet is that it will help us determine under-reporting or inconsistent reporting with respect to combination, business versus non-business income, and the apportionment factors.

The other major action is to increase significantly the number of IRS auditors who examine international transactions. It is apparent why this is important to a state currently using the worldwide method. By changing to a water's edge approach, that state will rely more on the IRS to determine what income is properly attributed to domestic economic activity.

In conclusion, I think the recommendations of the Working Group should be supported. They set a reasonable parameter for state taxation, and they identify the proper role for Congress in resolving this matter. Thank you for the opportunity to share Illinois' perspective with the subcommittee on this important issue.

TESTIMONY OF
SCOTT M. MATHESON, GOVERNOR
STATE OF UTAH
ON UNITARY METHOD OF TAXATION

In October, 1983, when I was invited to be a member of the Worldwide Unitary Taxation Working Group, I, along with many others, was dubious as to productive results of such an undertaking. After all, for over twenty years study groups and committees on a federal and state level had been unable to resolve this complex problem. It is worthy of note that Senator Mathias has been working for twenty-two years on legislation to prohibit worldwide unitary combination by federal law.

As the activities of the working group progressed and the technical work of the task force continued, I was encouraged that a resolution could be reached. It became apparent the "waters edge" approach should resolve the problem with our trading partners and still maintain the rights of the states in establishing their tax policies.

While the report of the working group did not resolve all the concerns of states, industry, the federal governments and our trading partners, many of us felt it provided options and recommendations that would provide an adequate framework for resolution.

We, in the State of Utah, have accepted the report in a very positive frame and are proceeding to implement rules and regulations which we believe will resolve many of the problems which have been identified.

Let me mention for emphasis the three principles of agreement and comment briefly.

Principle One: Water's edge unitary combination for for U.S. and foreign based companies under certain conditions.

Principle Two: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.

Principle Three: Competitive balance for U.S. and foreign multinationals and purely domestic businesses.

There are several points regarding these principles which I would like to make.

Point #1. The set of principles recommended by the working group is to be used as a guide in the formation of state tax policy. Principle number one, particularly, would be implemented by state action rather than federal restrictions.

Point #2. As a condition for the states limiting unitary combination to the waters edge, the federal government would enact a federal law requiring a taxpayer to file information disclosing its tax liability, and the method of calculation for each state in which it operates.

In other words, the resolution of the issue at hand requires a partnership between industry, states and the federal government.

The State of Utah is proceeding in good faith that each partner will hold up their end of the agreement. By January 1, 1985 the State of Utah should have in place rules and regulations whereby worldwide unitary will be replaced with waters edge method of taxation. Adequate time will be given to this process which will require public hearings.

My testimony on this issue would not be complete without mentioning the areas of disagreement, primarily, the foreign dividend issue and the "80/20" corporations. I agree that states should retain the right to tax dividends paid to U.S. multinationals by their foreign subsidiaries. I further believe

the states should have the right to grant relief, either factor relief or a percentage relief, or even total relief if they so choose, to foreign dividends repatriated to the United States. Such resolution would be at the state's option.

The resolution of how to handle a U.S. corporation with primarily foreign operations, popularly known as "80/20" corporations should also be achieved at the state level.

The bottom line on this whole issue is equity and fairness. We must be careful then not to implement any policy which, as a result of arbitrary percentages, creates any opportunity for tax avoidance.

In conclusion, let me reemphasize Utah's commitment to resolve the complex problem of unitary method of taxation at the state level using the guidelines contained in the final report of the Worldwide Unitary Taxation Working Group. I am persuaded the results will be welcomed and will prove satisfactory to all concerned.

My admonition to this committee is to allow the states to respond to said recommendations and let federalism work rather than to attempt to force federal restrictive legislation down our throats.

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

ALBERT D. BOURLAND
VICE PRESIDENT
CONGRESSIONAL RELATIONS

October 5, 1984

1015 H STREET, N.W.
WASHINGTON, D.C. 20002
202/463-5600

The Honorable Charles McC. Mathias
Chairman
Subcommittee on International Economic Policy
Committee on Foreign Relations
Washington, D.C. 20510

Dear Senator Mathias:

On behalf of the Chamber of Commerce of the United States, the world's largest federation of companies, local/state chambers of commerce and trade/professional associations, I commend you for your continued interest in resolving the problem created by states use of the worldwide unitary system of taxation.

The Chamber has long been opposed to state taxation of foreign source income and has supported your bills to prohibit the states from using the worldwide unitary system of taxation. Continued use of worldwide combined reporting by certain states threatens the ability of the United States to adopt a single international trade and tax treaty policy and results in multiple taxation and overly burdensome compliance costs for businesses operating in interstate commerce.

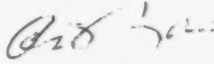
We commend the Administration for creating a Working Group to try to reach a solution to the problems caused by the worldwide unitary tax which would be acceptable to the business community, states, and federal government. However, the Final Report of the Working Group leaves to the states the adoption of water's edge application of the unitary tax system and the decision of whether or not to tax foreign source dividends and 80/20 companies. This may not resolve the problem.

The recent action by Oregon indicates progress in this area, and we are encouraged that Florida and Indiana may also take positive steps to discontinue their use of the worldwide unitary tax system. However, recent legislation considered by California is a move in the wrong direction because it would still result in double taxation of international income. The California legislation, which would have implemented water's edge unitary taxation with taxation of foreign source dividends, could result in as much as a 50 percent increase in the state tax liability of U.S. multinationals. This is the result of taxing dividends from foreign subsidiaries, which have already been taxed by foreign governments.

We appreciate your continued opposition to the worldwide unitary tax system and hope that you and this Committee will continue efforts to see that the problems created by this state taxation system are resolved.

I ask that this letter be made a part of the hearings record.

Sincerely,



Albert Bourland



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Statement before the

Senate Foreign Relation Committee

on

States' Use of the Worldwide

Unitary Method

October 3, 1984

in the public service

The American Federation of State, County and Municipal Employees submit for the record of the Senate Foreign Relations Committee, this statement on states' use of the worldwide unitary method. AFSCME is the largest AFL-CIO affiliated union, representing more than 1 million public employees at all levels of government.

We are very troubled by the possibility of federal restrictions on the ability of states to use the worldwide unitary method for apportioning corporate income. The basic issue concerning states' use of the worldwide unitary method is tax avoidance by multinational corporations. The difficulty of determining the in-state income of multinational corporations is a serious problem. Without the ability to use a worldwide unitary approach for allocating corporate income, states cannot ensure that multinational corporations are paying their fair share of taxes.

The Advisory Commission on Intergovernmental Affairs (ACIR), a bipartisan body representing executive and legislative branches of federal, state and local government and the public, less than two years ago completed a serious examination of whether federal restrictions are needed. In that study, ACIR found that

"it is clear that (a) our federal system allows the states the widest latitude in determining their own tax structures, (b) the judicial system provides processes for determining

whether state tax practices conflict with constitutional standards. (C) business enterprises in our federal system are free to locate in states that provide the most congenial tax climate and (d) there is not evidence that state tax practices cause harm to the nation. Therefore, the Commission recommends that the United States Congress pass no law that will limit state tax practices with respect to multinational corporations or "foreign source" income.(1)

We strongly concur with ACIR's recommendations. As we will explain, worldwide unitary is the most fair and reasonable method for states to apportion corporate income. The Supreme Court in its Container Corporation v. Franchise Tax Board decision, which was released after the ACIR study, rejected the objections raised by multinational corporations on the constitutionality and properness of California's worldwide unitary method. Moreover, multinational corporations' claims of serious national economic harm remain unsubstantiated. And, the harmful consequences of federal restrictions to states are very real.

Merits of the Worldwide Unitary Method

The worldwide unitary method is the fairest, most consistent and most efficient method of apportioning the profits of a multinational corporation to a state. It says that, if 6 percent

of a multinational corporation's worldwide payroll, assets and sales are in a particular state, then 6 percent of the multinational corporation's worldwide profits should be taxed by the state.

The worldwide unitary method recognizes the complexity of modern business operations that cross state and national boundaries and that involve subsidiary corporations. For such complex business operations, no precise method of allocating profits is possible. Worldwide unitary, however, provides a reasonable "rough approximation" of income generated in a state by a multinational corporation.

Just last year, the United States Supreme Court ruled in Container Corporation vs. Franchise Tax Board that the worldwide unitary method applied by California was fair and constitutional.(2) In reaching this decision, the Supreme Court rejected the Container Corporation's arguments that the worldwide unitary method was unreasonable and arbitrary because foreign subsidiaries may be significantly more profitable or lower foreign wages may distort the three factor formula for allocating income. The Supreme court also dismissed the business argument that worldwide unitary would increase the likelihood of double taxation.

The main alternative to the worldwide unitary approach, known as the arm's length or separate accounting method, is archaic and unworkable. The arm's length method is a throw-back

to an earlier time and is unable to cope with the complexities of modern multinational business operations.

An arm's length method tries to treat separately the subsidiaries of a large corporation even though they are controlled by the same management and are part of an integrated business operation. In order to enforce this artificial separation, the arm's length method must calculate transfer prices for goods and services traded between subsidiaries. Such transfer prices are difficult, if not impossible, to calculate because of the lack of comparable market prices. Through the manipulation of transfer prices, multinational corporations are able to shift profits among subsidiaries for the sole purpose of avoiding taxation.

A thorough examination of the Internal Revenue Service's (IRS) enforcement of the arm's length method by the General Accounting Office (GAO) found the method to be "uncertain and burdensome to both the IRS and the corporate taxpayer." According to the GAO study, only 3% of the corporate income adjustments made by the IRS were based on transfer prices because of a lack of comparable, uncontrolled prices. The problems of enforcing the arm's length method led the GAO study to recommend that:

"the Secretary of the Treasury initiate a study to identify and evaluate the feasibility of ways to allocate income under section 482,

including formula apportionment, which would lessen the present uncertainty and administration burden created by the existing regulation"(3)

States are at a far greater disadvantage than the federal government in enforcing the arm's length method. With fewer resources available for enforcement, multinational corporations can easily manipulate transfer prices to avoid state taxation. Worldwide unitary, which treats the subsidiaries of multinational corporations as a unified business and prevents shifting profits to avoid taxation, represents the most practical and reasonable approach for state to use in allocating corporate income.

Opposition To the Worldwide Unitary Method

Since the precedent setting Supreme Court decision in Container Corporation v. Franchise Tax Board, multinational corporations have undertaken a massive campaign against the worldwide unitary method. They are pressuring Governors and State Legislatures, as well as the President and Congress, to restrict states' use of the worldwide unitary method. They have even resorted to enlisting a number of foreign trade and government officials to pressure American public officials.

The reason is simple: they do not want to pay their fair share of taxes. And what is at stake is not just state's use of the worldwide unitary method. The fear of multinational corporations is that states will set an example for third world, and even possibly developed nations.

The multinational corporation's arguments against states' use of the worldwide unitary method reveals their desperation. Many of the arguments put forth by multinational corporations are those already rejected by a Supreme Court that is not unsympathetic to business interests. Among the rejected arguments still posed by multinational corporations are that the three factor apportionment formula is arbitrary and unreasonable and that the worldwide unitary method results in double taxation.

The multinational corporations chief argument against worldwide unitary is its economic consequences. According to multinational corporations, the worldwide unitary method causes serious national economic harm. The experience of states that use the worldwide unitary method raises serious doubts about this assertion.

A look at the three largest states using the worldwide unitary method - California, Florida and Massachusetts - reveals that multinational corporations' predictions of economic calamity are simply empty threats. The table below compares the economic performance for 1983 and projections for 1984 of these three states to the nation. Each of these three states out-performed the nation in 1983 and are expected to post greater economic gains in 1984.

Comparison of Economic Trends
in California, Florida and Massachusetts
to the Nation

	United States		California		Florida		Massachusetts	
	1983	1984	1983	1984	1983	1984	1983	1984
Unemployment Rate	9.4%	7.5%	10.0%	7.8%	8.8%	6.9%	7.0%	6.0%
Personal Income Growth	6.3%	9.5%	7.3%	10.9%	8.2%	11.6%	8.0%	9.3%
Non-Agriculture Employment	0.4%	4.1%	0.5%	5.8%	3.0%	6.5%	1.3%	3.3%

Source: Data Resources Incorporated Summer Forecast

Beyond these aggregate indicators, each of these three states appear to be doing quite well in obtaining new investments and new business development. California, which has used worldwide unitary for more than ten years, leads the country in foreign investment. In 1981, over 240,000 California were employed in non-bank, foreign owned firms -- 18% more than the second highest state.(4) Meanwhile, California and Massachusetts are recognized as the leading states in high-technology industries. And Florida, which enacted worldwide unitary in 1983, has recorded more than \$5 billion in new investment since the end of 1983.(5) A business climate study by Alexander Grant and Company ranked Florida as having the best business climate in the nation for 1983.(6)

The fact that worldwide unitary is not a major detriment to state economic growth is no surprise. Study after study has revealed that state taxes are not a key factor in business

location decisions.(7) Far more important than taxes are the condition of roads, bridges and other infrastructure, the location relative to markets and the availability of skilled labor. Whatever disincentive multinational corporation claim that worldwide unitary poses for business investment appears more than compensated for by its economic benefits: lower tax rates on other taxpayers, particularly small in-state businesses, and improved public services.

It is clear that multinational corporations' case against worldwide unitary is more a matter of rhetoric than reality. They rely on piecemeal, anecdotal evidence to make their case against the worldwide unitary method. The burden of proving serious national economic harm rests squarely with the multinational corporations. At this time, no reasonable evidence is forthcoming. And the protests of foreign governments are less than compelling when foreign corporations continue to invest in worldwide unitary states and no retaliatory tax measures are being seriously considered.

Harmful Consequences to States

The consequences of possible federal restrictions would be harmful to states. The cost of federal restrictions could reach 10 to 15 percent of corporate income taxes collected in the eleven states that currently apply the worldwide unitary method.(8) The twenty other states that apply to a domestic unitary approach could also be liable to losses through

restrictions on taxing foreign dividends. In California, alone, repealing worldwide unitary in favor of a strict domestic unitary approach would cost the state \$340 million annually, according to the Franchise Tax Board. (9)

Such hefty revenue losses from federal restrictions would require difficult choices: taxes on in-state businesses and individuals would have to be boosted and/or needed public services would have to be reduced. In Florida, for example, the revenues generated by worldwide unitary have financed improvements in education. The possibility of federal restrictions could mean curtailing these education improvements. Alternatively, Florida could require an average increase in the state's corporate income tax of over \$3,000 for the state's more than 300,000 business establishments -- most of them small in-state firms.

Federal restrictions would squeeze the tight budgets of many states. Despite years of tax increases and budget cuts, the fiscal situation of state governments remains strained. A recent National Governor's Association (NGA) survey estimates the total reserves of all states for last fiscal year to be just \$3 billion or 1.8 percent of spending -- far below what is considered a prudent level. By comparison, in 1981 total reserves stood at \$6.2 billion or 4.5 percent of spending. And, according to the NGA survey, 21 states ended last fiscal year with reserves of less than 1 percent -- not enough to even finance a week of state operations. (10)

Over the last four years, Congress has approved drastic cuts in federal aid to state and local governments. An AFSCME report, prepared by Fiscal Planning Services, Incorporated, estimates the losses in federal aid to state and local governments to be \$59 billion from pre-Reagan policy levels.(11) These cuts exacerbated the fiscal problems of state and local governments. Any new federal restrictions on states' taxing authority would only make matters considerably worse for state and local governments.

More importantly, federal restrictions would fuel taxpayer anger with the tax system. Public support for taxes, and public services in general, requires that all taxpayers contribute their fair share. Federal restrictions would allow multinational corporations to avoid paying much of their state tax liability, and would likely shift a considerable portion of that tax burden onto other taxpayers--especially middle and lower income families and small businesses.

Conclusion

The case for federal restrictions on state's use of the worldwide unitary method is, thus, not very persuasive. The merits of the unitary method, the absence of serious national economic consequences and the potential harm to states are strong arguments against federal restrictions. Finally, states are presently involved in a strenuous debate on the worldwide unitary issue. It is a healthy debate, and one which should be free from federal interference.

Footnotes

1. Advisory Commission on Intergovernmental Relations, State Taxation of Multinational Corporations, April, 1983.
2. Container Corporation of America, Appellant v. Franchise Tax Board, No. 181-853, June 27, 1983. Also, see AFSCME Brief in case for more details.
3. GAO, IRS Could Better Protect U.S. Tax Interests In Determining The Income of Multinational Corporations, September 30, 1981, see Digest.
4. Data from U.S. Commerce Department reports.
5. As reported in Sales Prospector, May/June 1984.
6. "Florida top draw manufacturing firms," USA Today, April 17, 1984, p. B1.
7. See for instance Michael Kieschnick, Taxes and Growth, Council on State Planning Agencies; Fortune Market Research Survey, "Why Corporate America Moves Where."
8. Sheffrin and Fulcher, "Alternative Divisions of the Tax Base: How Much is at Stake," University of California, Davis, 1983.
9. Memorandum of Franchise Tax Board on "Revenue Impact Study-Water's Edge vs. Worldwide Combination, May 10, 1984.
10. National Governor's Association, Fiscal Survey of the States, 1984, July, 1984.
11. The States, The People and the Reagan Years, American Federation of State, County and Municipal Employees, April, 1984.